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"Starve the Beast" – Discount Taxes and Increase Jobs by 18,000!

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

The March 2010 state unemployment rate stands at 6.8 percent, the highest level since September 1986, and double the rates that were seen as recently as mid 2001.[4] As this rate has increased, so have concerns about the overall economy, manifesting in a more cautious consumer. As discretionary spending falls, the sales-tax base shrinks. In addition, income-tax receipts decline as unemployment grows.

In Governor Culver's proposed FY2011 budget, a comprehensive review of the state government found $341 million in government inefficiencies, justifying a reduction of that amount to the annual budget.[5] Legally required to balance the state budget, Governor Culver set forth a plan to narrow the gap by $1.011 billion. Cutting state spending by $520 million in addition to $150 million received from the federal government would supplement the $341 million in cost reductions from eliminating inefficiencies.[6]

Governor Culver is also addressing government inefficiencies, including one-time cost savings, such as joining multi-state lawsuits on escheat of unclaimed bonds. Other examples include the consolidation of areas of the state government, eliminating the least efficient state printing shops, and negotiating statewide contracts. However, these inefficiencies tell another story ─ one that has less to do with the vagaries of state revenue and more to do with the fact that government spending has crowded out private investment.

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

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

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at the rate of 5.4 percent and $5.40 in sales tax revenue on the same item.

The Beacon Hill Institute at Suffolk University (BHI), at the request of IDT, analyzed the fiscal and economic impact of different levels of tax discounts. We considered tax discounts of five, ten, and 15 percent applied to three major tax categories: state sales tax, state income tax, and local property taxes, including both commercial and personal property. In conducting this analysis we used the STAMP – State Tax Analysis Modeling Program.

Results

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

Table 1 Economic Effects by Tax Discount Percent

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

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

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

But what are the static and dynamic effects to Iowa state revenues? If you cut tax rates, won't tax collections fall? And if tax collections fall, won't services be negatively impacted?

The static revenue decreases are calculated by multiplying the tax discount — five, ten, or 15 percent — by the projected revenue collections. This static revenue decrease, however, does not tell the whole story. When taxes are reduced, the state becomes more competitive, resulting in increased economic activity.

For example, a reduction in sales taxes by five percent enables

Iowa Statewide Economic Indicators

Data source: <http://www.iowaworkforce.org/trends> April 20, 2010

Latest Economic Indicators	Updated as of:	Actual Number	Amount of Change	Time Period Reported
New Vehicle Registrations	3/26/2010	1,060	14.6%	January 2009 - January 2010
New Housing Permits	3/26/2010	270	56.1%	February 2009 - February 2010
Existing Home Sales	2/12/2010	66,800	9.9%	3rd Quarter - 4th Quarter 2009
Total Resident Jobs	4/16/2010	1,570,500	-9,800	March 2009 - March 2010
Non-Farm Employment	4/16/2010	1,474,200	-16,200	March 2009 - March 2010
Factory Jobs	4/16/2010	199,800	-8,600	March 2009 - March 2010
Initital Unemployment Claims	4/16/2010	21,903	-7.4%	February - March 2010
Jobless Rate	4/16/2010	114,600	25.5%	March 2009 - March 2010
Personal Income	4/9/2010	$36,751	-1.6%	4th Quarter 2008-4th Quarter 2009
Exports of Goods	4/1/2010	$8.9 billion	-25.4%	January 2009 - January 2010
Farmland Values	3/12/2010	NA	2.0%	January 2009 - January 2010

cheaper prices for goods; thus, at the margin, more goods would be sold, increasing the sales tax base. Moreover, the increased economic activity would also raise incomes, which would, in turn, boost personal income tax collections. In this case, the dynamic revenue loss would be less than five percent.

Table 2 displays our estimates of the static and dynamic revenue changes. Under a five percent tax discount, sales- and income-tax revenues would drop by $144 million and $141 million respectively, for a combined state-level, static, tax-revenue loss of $285.52 million. A five percent discount on local commercial and personal property taxes would yield a static revenue loss of $180.79 million. A ten percent tax discount in the state sales and incomes taxes would produce a static decrease of $571.02 million combined, while a local level ten percent decrease in property tax rates would lead to a revenue drop of $361.58 million. A 15 percent tax discount would deliver a total static revenue loss of $1,398.91 million — $542.37 million from local property tax and $856.54 from state discounts.

However, the dynamic revenue losses would be less than the static, due to the positive effects of a lower tax burden on businesses and households. For the five percent discount on sales and income taxes the dynamic revenue loss would be only $179.41 or 2.61 percent of total revenue, due, in part, to a rise in other state tax revenues of $55.79 million. The dynamic effects would shrink the loss to $165.94 million, or 4.25 percent of local property-tax revenue. The ten percent tax discount would result in a 5.42 percent decrease in state taxes, or $372.04 million, while local property taxes would decline by $338.32 or just 8.66 percent. The 15 percent discount on the state taxes would lead to only an 8.17 percent, or $561.30 revenue loss, while a 15 percent discount on local property taxes would reduce receipts by $512.03 or 13.11 percent.

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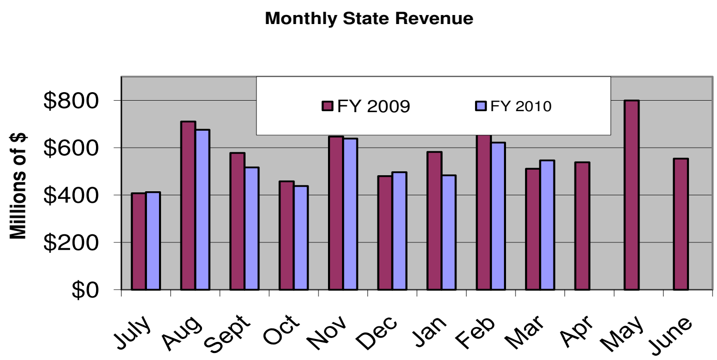
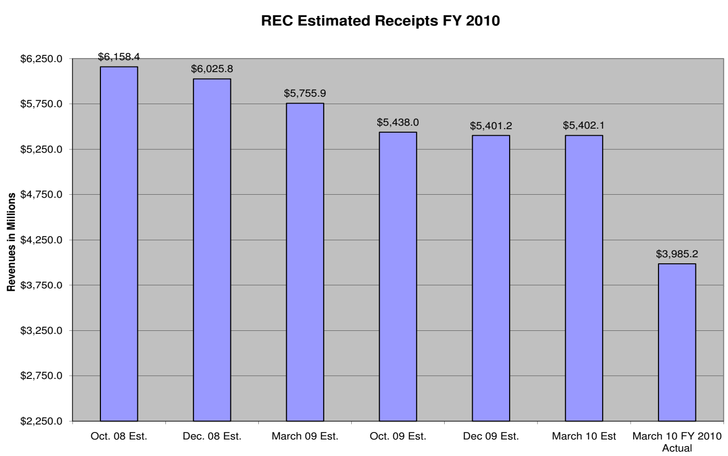
Iowa's Monthly State Revenue and Estimated Net Yearly Revenue (in millions)



Iowa's Monthly State Revenue:

Monthly FY 2010 state revenue was $546.2 million in March 2010. This is $35.1 million more than the same month in FY 2009. The major increase was in Personal Income Taxes collected, up 7.1 percent from March 2009.

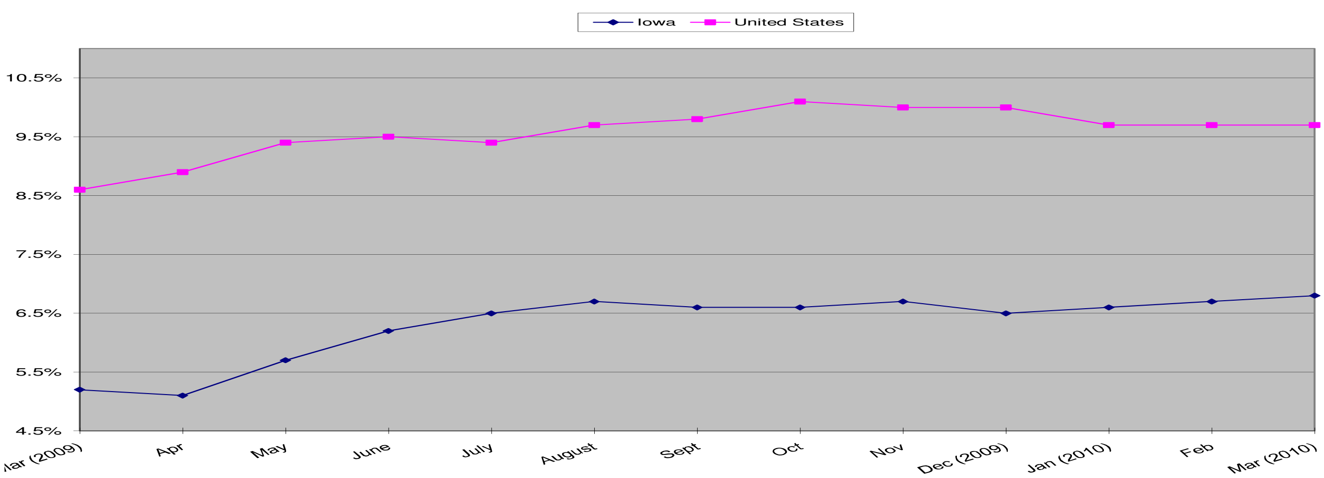


Iowa's Estimated Net Yearly Revenue:

The revised Revenue Estimating Conference March number for FY2010 Net General Fund receipts is now $5,402.1 million. This is down $756.3 million from the original October 2008 estimate, but up slightly from December 2009. As of March actual tax revenue collected was $4,829.0 million.

Source: Legislative Services Agency "Monthly General Fund Revenue Memo," and Revenue Estimating Conference Report

U.S. and Iowa's Unemployment, March 2009 - Current



The U.S. unemployment rate in March 2010 was 9.7%, the same rate since January 2010. After dipping in December, the Iowa rate has crept up slightly each month since, to 6.8%. This is up from 3.8% in December 2007. Total employment in March was 1,570,500, down 10,600 from last March. The number of unemployed persons was 114,600, over 23,300 more than a year ago. Currently, many of those unemployed have been looking for work for a year or more.

Source: Iowa Workforce Development, Labor Market Information Bureau, "Monthly Unemployment Rate News"

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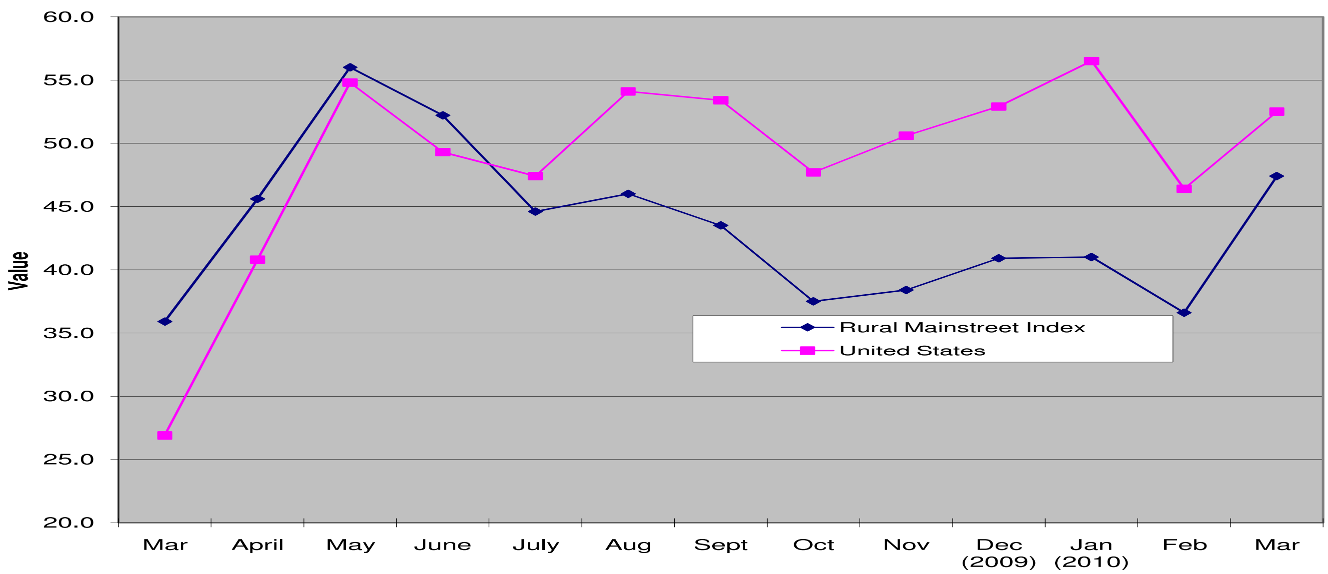
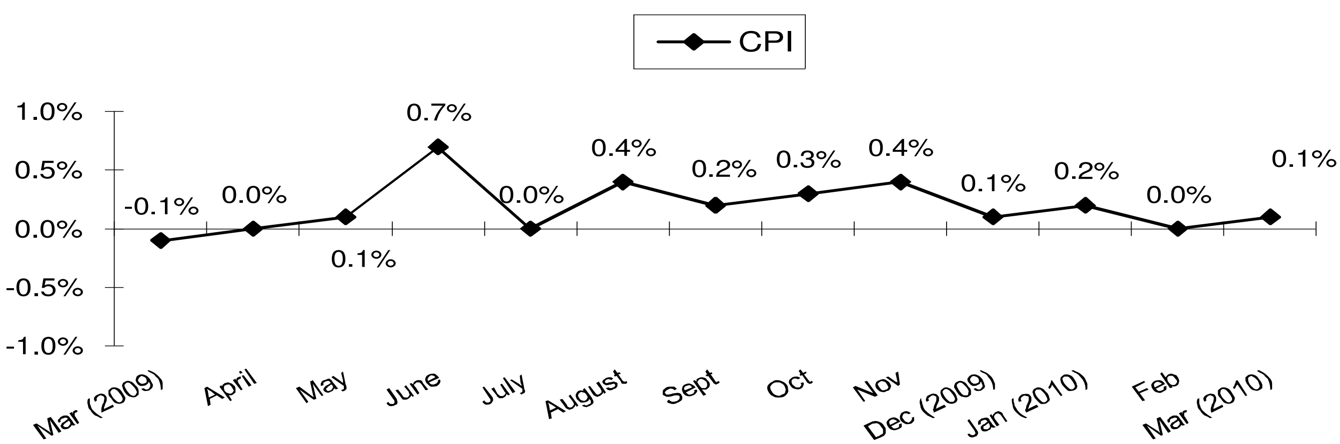
Consumer Confidence Index



As of March 2010, the Consumer Confidence Index (CCI) rebounded from a February drop, in both Iowa and the U.S. as a whole. According to the Conference Board, "consumers continue to express concern about current business and labor market conditions. Their outlook for the next six months is still rather pessimistic." The Creighton University Rural Mainstreet Index for the Midwest region reflects growth in agricultural equipment and land sales, which is "expected to remain healthy in the months ahead."

Source: Conference Board, "Consumer Confidence Survey" and Creighton University

Consumer Price Index, Monthly Change



The seasonally adjusted Consumer Price Index increased 0.1% in March 2010, driven by an increase in fresh fruits and vegetables following a cold winter season. There were declines in the gasoline and natural gas indexes, while medical care and both new and used vehicles posted increases. Decreases were seen in shelter, household furnishings, and apparel, reflecting continuing consumer spending restraint.

Source: U.S. Department of Labor, Bureau of Labor Statistics

Revenue Estimating Conference Estimate of General Fund Receipts will return in August. The March 2010 Report may be found at http://www. dom.state.ia.us/state/files/FY10/10-03%20REC%20Final.xls

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Table 2

Government Revenue by Tax Category for FY2011

	5%	10%	15%
Static Revenue Change ($m)			
Sales Tax	-144.32	-288.63	-432.95
IncomeTax	-141.2	-282.39	-423.59
Property Taxes	-180.79	-361.58	-542.37
Total	**-466.3**	**-932.61**	**-1,398.91**
Dynamic Revenue Change ($m)			
State Level Collections			
Sales Tax	-103.86	-213.14	-324.79
Income Tax	-131.34	-261.53	-388.83
Other Revenue	55.79	102.63	152.31
Total	**-179.41**	**-372.04**	**-561.3**
Percent of State Revenue	-2.61	-5.42	-8.17
Local Level Collections			
Property Taxes	-165.94	-338.32	-512.03
Percent of Local Revenue	-4.25	-8.66	-13.11
Total State and Local Revenue	**-345.35**	**-710.36**	**-1,073.33**

Conclusion

Current economic circumstances, with unemployment high and continuing to increase, would suggest the immediate implementation of the largest discount of 15 percent on income and sales taxes. This level would create the largest number of jobs, grow the Iowa economy, and provide relief to taxpayers who are concerned about their finances. Over 18,000 Iowans will have new jobs. They will no longer draw unemployment checks, but will instead contribute positively to the economy and support their families.

As Governor Chet Culver's FY2011 state budget already shows, there are at least $341 million in current inefficiencies and overspending in state government. These cuts can be made with no negative result to the citizens receiving services. At the 15 percent tax-cut level, another $189 million, or about three percent, in additional spending would have to be cut. This is a relatively minor amount of the total budget, and should be able to be found. The legitimate and doable spending cuts proposed by the Republican Legislators, and ignored by the majority Democrats, during the just-ended 2010 session were more than double that amount.

As for IDT's proposed discount on property taxes, cities and counties should implement a minimum five percent discount in order to provide taxpayer relief, taking advantage of the opportunity to grow their local economies by becoming as competitive as possible. Discounts of up to 15 percent on property taxes should be considered by cities and counties that are stronger financially, or those that simply choose to be as aggressive as possible in stopping the loss of current residents and businesses to other states, and especially for the purposes of attracting new ones.

Whichever states, counties, and cities seize the initiative to begin discounting taxes will have the advantage in maintaining current residents and businesses, but especially in attracting new ones to grow their economies and tax bases. From a fiscal standpoint, the elimination of $341 million in inefficient government spending implies that when the state economy rebounds, there will be excess revenue, and thus room to discount taxes. If Iowa lawmakers implemented an across-the-board ten percent discount in the state personal income and sales tax, the combined revenue loss would be $372.04 million dollars.

Thus, we conclude that Iowa's state and local governments can afford to implement a ten percent tax discount, with little change in public services provided.

Methodology

To identify the economic effects of the tax discounts and understand how they operate through a state's economy, BHI utilized its STAMP (State Tax Analysis Modeling Program) model. STAMP is a five-year dynamic CGE (computable general equilibrium) model that has been programmed to simulate changes in taxes, costs (general and sector-specific), and other economic inputs. As such, it provides a mathematical description of the economic relationships among producers, households, governments, and the rest of the world. It is general in the sense that it takes all the important markets, such as the capital and labor markets, and flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and capital). This equilibrium is achieved by allowing prices to adjust within the model. It is computable because it can be used to generate numeric solutions to concrete policy and tax changes.[7]

BHI used four STAMP models ─ New York State, Indiana, South Carolina, and Virginia – to garner an approximate effect that a five, ten, or 15 percent reduction in major tax categories would have on state economic indicators. In each of these models, BHI reviewed changes to the state income tax, state sales tax, and local property taxes on both commercial and personal property to approximate tax change elasticities for each economic variable.[8] The calculated economic effects enabled BHI to estimate the effect to specific Iowa economic variables, such as private employment, investment, and disposable income.[9] BHI then calculated the static revenue decrease of the given tax reductions, five, ten, or 15 percent, in each of the tax categories, and solved the model for each of the four states. An average of percent changes to each of the economic variables was then applied to the 2009 economic variables for Iowa. Each estimate represents the change that would take place in the indicated variable against a "baseline" assumption about the value of that variable for each of the tax reduction policies.

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

(Endnotes)

[1] General Assembly of Iowa, Legislative Service Agency, "FY 2011 General Fund Budget Projection," November 25, 2009, <http://www.legis.state.ia.us/lsadocs/IssReview/2010/IRDLR000.PDF> (February 16, 2010).

[2] Rod Boshart, "Budget deficit to dominate Iowa legislative sessions," *Quad City Times,* January 3, 2010, <http://www.qctimes.com/news/local/government-and-politics/article_17d57778-f81d-11de-bdf9-001cc4c03286.html> (February 16, 2010).

[3] Butch Heman, "Kettering, Roberts question governor's budget," *Daily Times Herald,* February 1, 2010, <http://www.carrollspaper.com/main.asp?SectionID=1&SubSectionID=1&ArticleID=9595> (February 16, 2010).

[4] News Release, Iowa Workforce Development, "Iowa Employers Add 7,300 Jobs In March; Iowa Unemployment Rate Edges up to 6.8 Percent" <http://www.iowaworkforce.org/news/xcnewsplus.asp?articleid=81&cmd=view> (April 16, 2010).

[5] Office of the Governor, "Fiscal Year 2011 Iowa Budget Recommendations," January 27, 2010, <http://www.dom.state.ia.us/state/files/budget_recommendations/FY11/FINAL_FY11BUDGETREPORTRevised3%20FINAL1272010.pdf> (February 16, 2010).

[6] Ibid.

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

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

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

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