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SUMMARY OF RESEARCH FINDINGS

for

THE GOVERNOR'S STUDY

of the

TAX STRUCTURE OF THE STATE OF IOWA

Submitted by
Dr. James A. Papke
Director of Research

"...to conduct a thorough study and evaluation of the need for revising and equalizing the tax structure of the state of Iowa." (House Joint Resolution 28, Sec. 1, Sixty-first General Assembly)

Des Moines, Iowa
June 30, 1966
Rev. September 1966

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STATE OF IOWA
OFFICE OF THE GOVERNOR
DES MOINES

HAROLD E. HUGHES
GOVERNOR

June 28, 1966

The Honorable Robert D. Fulton
Lieut. Governor - President of the Senate
State Capitol
Des Moines, Iowa

The Honorable Vince Steffen
Speaker of the House of Representatives
State Capitol
Des Moines, Iowa

Gentlemen:

In compliance with House Joint Resolution 28 of the Sixty-first General Assembly, I hereby transmit to you the "Summary of Research Findings" in connection with the Iowa Tax Study. Copies of this report, prepared by Dr. James A. Papke, director of the Tax Study, are being distributed to members of the Tax Study Advisory Committee today and will be forwarded to all members of the General Assembly within a few days.

Sincerely,

Harold E. Hughes

HAROLD E. HUGHES

HEH:bep

LETTER OF TRANSMITTAL

June 28, 1966

Honorable Harold E. Hughes,
Governor of Iowa
Des Moines, Iowa.

Dear Sir:

I am pleased to submit to you the summary of the research findings of the study of the tax structure of the State of Iowa. It is my earnest hope that the results of the research effort will help to point the way to a coordinated and balanced program for tax reform in Iowa.

This summary report has been made purposefully brief. Several hundred pages of economic analyses, statistical data, exhibits and other materials are now in the process of being assembled for presentation to you as a compilation of the full staff papers.

I am very much indebted to a large number of state government officials who managed to find the time and resources to gather vast quantities of statistical information and discuss various aspects of Iowa public finances with me. The full cooperation of Iowa State University and the University of Iowa is gratefully acknowledged. It should be mentioned, however, that responsibility for the content and format of the study, its conclusions and policy alternatives rests entirely with your Research Director.

Sincerely,

James A. Papke

James A. Papke
Director of Research

JAP/mhb

Enclosures

HOUSE JOINT RESOLUTION 28

A JOINT RESOLUTION

RELATING TO THE ESTABLISHMENT OF A STUDY OF THE TAX STRUCTURE OF THE STATE OF IOWA, AND TO MAKE AN APPROPRIATION THEREFOR.

WHEREAS, there have been a number of committees established in the past which have studied and submitted reports and recommendations on the tax structure of the state, and

WHEREAS, the majority of the studies have been able to concentrate only on specific areas of the tax structure of the state rather than having the time to make a concerted, detailed, and thorough study of all tax policies and programs affecting the state and governmental units thereof, and

WHEREAS, it is generally recognized throughout the state that there is a great need to revise the tax structure of Iowa for the purpose of equalizing the obligation of the payment of state and local taxes and to properly proportion the tax burden among the taxpayers of the state, NOW THEREFORE

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF IOWA:

Section 1. There is hereby appropriated to the office of the governor from the general fund of the state the sum of fifty thousand (50,000) dollars or so much thereof as shall be necessary, from which the governor shall contract for and employ such professional, technical, and other staff assistance as shall be necessary to conduct a thorough study and evaluation of the need for revising and equalizing the tax structure of the state of Iowa. Those responsible for the study shall have access to all public records and shall be given the cooperation of all public officials including all personnel of state universities and colleges. The governor may establish such advisory committees as may be necessary to carry out the purpose of this Act. The governor shall prior to July 1, 1966 submit a report to the general assembly on the results of the study, which report shall include recommendations for any needed changes in the tax structure of the state. All recommendations shall be accompanied by bills, where necessary, and copies of such bills shall be made part of the report.

Sec. This Act, being deemed of immediate importance, shall be in full force and effect from and after its publication in the Onawa Weekly Democrat, a newspaper published in

Onawa, Iowa, and in The Algona Upper Des Moines, a newspaper published in Algona, Iowa.

VINCENT B. STEFFEN
Speaker of the House

ROBERT D. FULTON
President of the Senate

I hereby certify that this Joint Resolution originated in the House and is known as House Joint Resolution 28, Sixty-first General Assembly.

WILLIAM R. KENDRICK
Chief Clerk of the House

Approved ________________________, 1965.

HAROLD E. HUGHES
Governor

I. INTRODUCTION: OBJECTIVES AND SCOPE

House Joint Resolution No. 28 of the Sixty-first General Assembly prescribed the scope of the Governor's Tax Study:

> "...to conduct a thorough study and evaluation of the need for revising and equalizing the tax structure of the state of Iowa."

In keeping with this broad directive, the primary objectives of the study were developed along the following three major lines: (1) to study the impact of the State and local tax structure on various kinds of economic activity; to quantify the possible and probable need for increased State-local revenue; to assess the degree to which the present tax structure apportions its responsibilities equitably among the citizens of the State; (2) to provide the Governor, the members of the General Assembly, and the citizens of the State of Iowa with a factual and analytical review and appraisal of their tax structure with the view to promoting an understanding of the structure and to facilitating its improvement and revision; and (3) to make such recommendations and proposals for adjustments in the existing tax structure as are considered necessary and desirable in order to remove inequalities and provide adequate revenue to meet the present and future needs of Iowa's State and local governments.

From the start, the foregoing objectives and the time constraint imposed by HJR 28 influenced in various respects the design of the research program. In the first place, the staff effort focused on major issues—on fundamental problems of tax policy. Comparatively minor sources of tax revenue and administrative details were not considered high priority research assignments unless they influenced or contributed directly to major problems of fiscal policy. Second, it addressed itself both to the State's imminent financial problems and to the State's likely fiscal position five and ten years ahead. Third, the research activity relied heavily on earlier Iowa tax studies, on nationwide trends in state-local finance, and on past and present experiences elsewhere. A concerted attempt was made to apply the lessons derived from the existing body of scholarship and to utilize the best analytical approaches developed to date by public finance scholars. And fourth, throughout the course of the study the intent was to present the required factual and descriptive data and objective appraisal and analyses in such a way as to facilitate policy deliberations and the drafting of recommendations. All tax sources were reviewed in the light of their contribution to the overall revenue needs of the state, of their equality in the distribution of tax responsibilities, and of their impact on economic development.

This brief summary of the research findings serves a threefold purpose: to comply with the July 1, 1966 target date for submission of the findings of the tax study to the legislature, to provide the basic framework for the conclusions and alternative fiscal policies, and to introduce the full staff report.

II. THE IOWA ECONOMY: PRESENT STATUS AND FUTURE PROSPECTS

In a very real sense, the Iowa economy is operating at full employment levels. As measured by the standard indices of economic performance, the Iowa economy is currently riding the crest and participating in the benefits of the continued expansion of the national economy. Employment and income gains recorded in Iowa manufacturing over the past year exceeded those in the nation as a whole. The remarkably low unemployment rate of 2.2 per cent of the labor force in Iowa was less than half of the 1965 national average. Iowa personal income, perhaps the best single indicator of the change in the economic status of the State's residents, reached record highs in 1965; at the same time the rate of increase was 25 per cent greater than that for the nation. The agricultural sector of the Iowa economy shared in this overall prosperity. Cash receipts from livestock marketings rose 16 per cent over the previous year, compared to 8.3 per cent for the rest of the nation. Similarly, the total value of agricultural output was up 10 per cent to a level of 3 billion in 1965.

The public sector of the Iowa economy also bore evidence of the bouyant economic climate. The aforementioned gains in personal income contributed to the expanding yields of the State and local tax structure. At the State level, these were translated into increased collections primarily from the personal and corporate income taxes, the retail sales and use taxes, and the group of selected consumption-type excises. For local governments, new construction and other capital investments influenced directly the productivity of the property levy. Capital outlay of manufacturers in 1965, for example, ran 50 per cent above the 1964 levels. On the expenditure side of the fiscal coin, this rapid economic development was accompanied by the usual increased demand for more and better quality public services, especially education.

What's ahead for Iowa? The long-range prospects, though subject to some uncertainties, are generally bright. The basic forces shaping the future posture of the State's economy are the same ones that have brought Iowa to its present state of development, namely technological progress, an expanding national economy, and the corresponding demand for Iowa's products. Over the next decade, employment will likely continue to shift away from agriculture and, to a lesser extent, manufacturing, to the service trades and industries. The Iowa economy should further solidify its position as a leading exporter of processed farm products, farm machinery, insurance and related goods and services. Expanding job opportunities can also serve to alter the direction of population migration. Thus, barring unforeseen national developments, the Iowa rate of economic growth in 1966 and in the years immediately ahead is expected to continue slightly higher than the national average.

III. THE IOWA TAX STRUCTURE: AN OVERVIEW

State and local taxes in Iowa amount to $259 per capita, about $10 above the national average. Property tax revenue of $146 per capita accounted for over one-half of the total. Iowa ranks fourteenth in the U. S. in terms of per capita property tax payments. Per capita non-property tax payments (income, sales, etc.) in Iowa are $25 below the comparable national average.

Thus in comparison with the rest of the nation, Iowa places relatively more emphasis on local property taxes for the support of public services.

Tax revenues have been increasing in recent years because of economic growth and rate adjustments under existing levies. But the State's productive capacity and income flows have kept pace with growth in the public sector and the result has been that the portion of income devoted to the purchase of State-local public services has not changed substantially over time.

IV. THE IOWA TAX STRUCTURE: ITS ADEQUACY

The adequacy of Iowa's state and local tax structure is measured by its capacity to finance the prospective increases in public expenditures over the next decade <u>without</u> frequent changes in the existing level of rates or tax bases. If State-local expenditures in Iowa continue to increase as rapidly as they have in recent years, expenditures in 1975 will be more than double the level of 1964-65. In certain important functional areas, notably eudcation, this past trend is not expected to continue. On balance, a somewhat slower rate of growth is anticipated for Iowa State-local expenditures in total. The "most likely" projection provides for an increase over the next ten years of $850 million, or 74 per cent above the 1964/65 levels.

It is estimated that the existing tax structure will produce $173 million of additional revenue over the next decade without <u>any</u> increases in tax rates, new taxes, or broadened coverage of old taxes. This "natural" or "automatic" increase in tax revenues at constant rates plus anticipated increases in federal aid and user charges will not, however, be sufficient to finance expenditures, in spite of the slowing down in the growth rate of the latter. By 1975, a projected revenue-expenditure imbalance of $266 million or about $27 million annually on the average over the decade needs to be filled by increasing the rates or adjusting the bases of existing taxes and/or adopting new forms of taxation.

Because of the residual character of the property tax and its susceptibility to small changes over time, local property tax rate increases will provide some of the required revenue. This appears to be far from an optimal solution. The best interests of the State of Iowa would seem to be served by implementing a positive policy of de-emphasizing the relative importance of the local property tax, via modification or roll-back, and relying more heavily on alternative sources of tax revenue whose yields are comparatively responsive to economic growth. Depending on the extent of property tax "de-emphasis", prospective revenue requirements could exceed yields under existing fiscal arrangements by as much as $100 million annually on the average over the next decade. Repeal of the entire personal property tax, for example, would "cost" other sources of revenue approximately $70 million per year. Replacement of the livestock component alone would require additional revenues amounting to $15 million annually.

V. THE IOWA TAX STRUCTURE: ITS EQUITY

Examination of the distribution of tax liabilities among Iowa households by income groups provides answers to the following questions: Is the present tax structure regressive, proportional, or progressive in its overall distribution of burden? To what extent does each major component of the present tax structure contribute to the overall distributional pattern? What proportion of the total tax collections are "exported" from the State and, consequently, borne by others than the residents of Iowa? Does the distribution of tax burden borne by Iowa residents follow some rational pattern and is it consistent with accepted notions of "fairness"?

As a result of the provision for the deductibility from business or personal income for federal income tax purposes of specified State and local tax payments, almost one fifth ($131 million) of Iowa State and local tax collections are "borne" by the federal government. Another 8 per cent ($56 million) is the responsibility of nonresidents who pay Iowa's taxes via purchases of goods produced in Iowa but sold out of the State. In total, Iowa residents, in their capacity as either consumers, producers, or owners of property, carry an estimated 75 per cent of the actual burden imposed by Iowa taxes. For 1964/1965, this amounted to $539 million out of a total $726 million of tax collections.

Iowa's present State-local tax structure is steeply regressive (i.e., tax burdens expressed as a per cent of household income decline as income increases) throughout the income range up to

$15,000 and progressive thereafter. The "average" family with income of $5,000 has State-local tax burdens relative to income which are 60 per cent greater than the "average" family with income above $10,000. The regressivity at household income levels below $5,000 is even more pronounced with taxes absorbing over 20 per cent of income. Thus, Iowa's tax system is inequitable when measured by the ability to pay standard.

The local property tax, particularly on residential real property (i.e., on the consumption of shelter) is primarily responsible for the overall regressive pattern of tax burden distribution. In the first place, it accounts for over 50 per cent of the total payments actually borne by all Iowa residents, and, in the second place, housing expenditures constitute a larger proportion of income of the lower income groups than of higher income groups. By comparison to the only other major tax source which distributes its burden regressively, namely the retail sales and use tax, the property tax is seven times as significant a contributor to the overall distribution pattern. The policy implication seems clear: as the major source of inequity in the existing state and local tax structure, <u>any</u> increased reliance on property taxation is an alternative to be avoided (assuming Iowa does not want to reinforce the already substantial regressivity of its tax structure).

The retail sales and use tax is mildly regressive throughout the income range. Iowa's individual income tax, on the other hand, is slightly progressive. But because the income tax provides less than 10 per cent of the total tax payments of Iowa residents, its distributional effects have little influence on the shape of the overall distributional pattern. The reciprocal offset provided by deductibility of the State income tax under the Federal income tax and of the Federal income tax under the State income tax is of critical importance in reducing the overall progressivity of the State individual income tax. It also severely restricts the revenue producing capabilities of the income tax.

If only equity (i.e., the treatment of the higher income groups in Iowa compared to the lower income groups) were at issue in the formulation of Iowa tax policy, the direction is clear: place increased reliance on the income taxes, both individual and corporate, and reduce, to whatever extent possible, the relative importance of the local property tax.

VI. THE IOWA TAX STRUCTURE: ITS MAJOR COMPONENTS

A. The Property Tax

The real and personal property tax in Iowa is currently producing some $413 million of revenue annually, virtually all of which (99.2 per cent) is levied by local (county, municipalities and school districts) governmental units. More than half (58.2 per cent) of the total property tax levy is used to support educational programs of the local school units. Measuring so-called property tax "burdens" by the ratio of net property tax levy (gross levy less homestead, agricultural land and military credits) to personal income received in Iowa indicates that the current level is lower than that borne in the pre-1940 period. In recent years, however, the ratio has been increasing. In other words, the rate of growth in the net property tax levy has been greater than the corresponding rate of growth in Iowa personal income.

Real property currently accounts for 84 per cent of the total property tax base. The remainder is derived from the tax on personal property. Inventories, livestock and farm machinery alone account for two-thirds of the levy on <u>all</u> tangible personalty.

The variety and magnitude of property tax exemptions account for approximately one-third of the current property tax rate. That is, if <u>all</u> exemptions were eliminated and <u>all</u> property made taxable, the present rate on non-exempt property would be about two-thirds of its present level. The primary burden of providing property tax exemptions is borne by owners of taxable property. The great part of this tax exempt value, however, has no relevance as a potential revenue source since it consists of government-owned property and other property which serves public-type purposes (non-public schools and colleges, hospitals, and the like). Property tax credits (homestead, agricultural land, and a portion of the veterans' exemption), on the other hand, do not add directly to the burden of the owners of non-exempt property, because they are being currently financed out of the State general fund. The credit provisions, being based on millage rates, may, however, provide some incentive to underassess property.

Substantial geographical inequality exists in the effective property tax rates (i.e., tax levy as percentage of market value) in Iowa. The estimated countywide median rates range from a low of 1.0 per cent in Carroll County to a high of 2.6 per cent in Wapello County. The complete exemption of personal property from the local property tax with the revenues being replaced by a revenue-equivalent state aid program would tend to favor rural counties, but not necessarily those counties with disproportionately high effective tax rates.

The Iowa local property tax is markedly regressive when measured against the distributional pattern of household money income. This is not surprising when the bulk of the tax is, in fact, a sales tax on housing consumption at rates exceeding 10 per cent. Poorer families of necessity spend proportionately more of their income on housing than do richer families.

Substantial revision or reform of the Iowa local property levy requires the weighing of the advantages and disadvantages among alternative fiscal measures. It seems clear, however, that the decision to continue with the property tax as it exists presently or allow it to increase in relative importance may not be the best of all alternative choices.

B. The Personal Income Tax

Comparison of recent Iowa personal income tax collections with those of other taxes reveals significant increases in the relative importance of the levy. Its annual rate of growth currently exceeds 8 per cent. Within the next decade, it is estimated that the revenues from the personal income tax will exceed those under the retail sales and use tax, even assuming no changes in existing rates or bases. Thus, from the point of view of the criterion of revenue adequacy, the personal income tax is a highly desirable component of the Iowa State-local tax structure. As to equity considerations, the levy constitutes the <u>only</u> non-regressive element in the present structure. Further, because of the modest statutory rates in combination with the broad deduction and exemption provisions, the tax has no measurable adverse economic effects. In short, the personal income tax, by comparison to the other components of the present tax structure, comes closest to satisfying the criteria of sound tax policy.

At least one feature of the Iowa personal income tax is not logically supportable, namely, the provision for the deductibility of <u>all</u> federal income tax paid. The combined impact of this provision on the tax yield, on the responsiveness of the levy to economic growth, and on the distribution of the burden of the income tax, greatly outweighs whatever arguments have been offered in defense of its retention. At the present time, the provision "costs" the State of Iowa (and consequently "other" sources of revenue) over $15 million per year, the majority of this 30 per cent revenue "loss" benefits taxpayers in the higher income brackets. Clearly, families in the very low income groups receive no or very nominal relief from the provision.

The influence of federal income tax deductibility on the distribution of State tax liabilities among household at different income levels is significant. With a progressive federal tax rate structure and federal tax deductibility, Iowa taxpayers at the lower end of the income scale pay a large proportion of the State tax. And what appears on the surface at least to be a mildly progressive statutory rate structure, in fact almost becomes a flat rate levy with the inclusion of this provision. Modifying the present unlimited deduction to one which carries a maximum of, say, $200 per taxpayer would improve the overall equity and effectiveness of the personal income tax and "save" the State of Iowa and "other" sources of revenue upwards of $12 million per year.

Recent enactment of withholding or pay-as-you-earn system under the Iowa income tax should also prove to enhance the equity, efficiency, and adequacy of the levy. From the standpoint of the individual, it provides a more convenient way of paying the tax and minimizes the hardships so frequently experienced when payment is made in a lump sum. Tax administration and enforcement should also be positively affected.

C. The Retail Sales and Use Tax

The Iowa 2 per cent retail sales tax applies to sales of tangible personal property at retail and a few selected services. For all practical purposes, the sale of personal consumer-type services is not subject to the tax. Currently the combination retail sales and use taxes are producing approximately $90 million annually, with an average growth rate of $2 million per year. Their automatic responsiveness to economic growth is considerably less than that of the personal income tax. In fact, retail sales tax payments as a per cent of personal income in Iowa have declined by 5 per cent over the last decade, confirming a well-known characteristic of traditional retail sales taxes: with income increases, expenditures on taxable purchases increase less than proportionately. This characteristic also explains the overall regressive distribution of tax liability under the retail sales tax. As income increases, tax liabilities as a percentage of income decrease. Interestingly, Iowa is almost unique among sales tax states, in that it still utilizes the 2 per cent rate originally included in the original 1934 statute. While most other states have adjusted their sales tax rates to meet the requirements of increased expenditures, Iowa has placed more reliance on other tax sources, notably the local property tax.

Examination and analysis of the Iowa retail sales and use tax payments disclosed the fact that contrary to commonly held notions of the tax as being exclusively or primarily a consumer levy, almost one quarter of the collections are derived from intermediate business purchases. Thus, for example, Iowa manufacturers are estimated to pay some $5 million in retail sales taxes on various types of purchases--purchases of goods which ultimately are included directly or indirectly in the manufacturing of products which are again sold at retail and to which the retail sales tax is again applied. The inclusion of substantial amounts of intermediate, inter-firm purchases provides the opportunity for a portion of the retail sales tax to be pyramided in prices, that is, increasing the price of final products by more than the amount of the tax imposed at successive stages.

Extending the retail sales tax to personal consumer type services would make the revenues from the State's retail sales tax more responsive to growth in the State's economy over the years and, at the same time, reduce the regressivity of the present tax. Not unimportantly, it would increase collections 20 per cent with a minimal amount of adverse economic consequences. Activities which might conceivably be included within the scope of the tax are laundry, dry cleaning, auto parking and rental, various repair services, and the like.

A strong case can be made for the adoption of a provision to exempt the basic necessities of life from the burden of retail sales tax via a year-end credit or rebate. Such a provision could eliminate entirely the regressive features of the tax with a minimum of revenue loss and administrative hardships. A flat $9 credit per person (exclusive of federal and state institutional population) would "cost" the State about the same amount as the aforementioned gain from the taxation of personal services. The argument can also be made for extending the credit or rebate only to individuals and families with low and moderate incomes. For example, a variable retail sales tax credit or rebate beginning, say, at $12 per person for families with incomes of less than $3,000 and diminishing by $3 for every $1,000 of income increase to a zero credit for income taxpayers with adjusted gross income for tax purposes greater than $6,000. The revenue "cost" of the variable type credit or rebate would amount to about $11 million annually, but it would eliminate the excessive burden of the sales tax on low income groups. The advantage of the credit device over the conventional over-the-counter exemption of specified commodities (food, prescription drugs, clothing, etc.) rests in its efficiency, precision, and low administrative costs. It would seem to be particularly appropriate to consider the adoption of the credit provision if additional revenue requirements focused on a retail sales tax rate adjustment and base extension.

If enabling legislation were passed permitting local option surtaxes on the State's retail sales tax, a rate of 0.5 per cent would generate an additional $11 million in revenue for municipalities with over 10,000 population. Towns in the 5,000 to 10,000 population category could raise an additional $2.5 million. Smaller towns and counties would share about $6 million of revenue from a 0.5 surtax. Surtaxes imposed on a countywide basis would be more efficient devices than similar taxes at sub-county levels.

D. The Business Tax System

For all intents and purposes, the Iowa business tax "system" consists of several hundred local property taxes imposed on real and personal property. Of the approximately $400 million in total taxes collected from Iowa commercial and industrial businesses, three-quarters or in the neighborhood of $300 million is accounted for by the local property tax. The remainder of business' share is made up essentially of selected consumer excises collected at the business rather than consumption level. The corporate net income tax, which yields about $6 million annually or less than 1 per cent of all State-local revenues can hardly be considered a significant component of the business tax "system". Thus, whatever, if any, adverse effects State-local taxes paid by Iowa firms may entail, they must rest almost entirely with the deficiencies inherent in the local property tax.

In its application to business, the local property tax is necessarily discriminatory. Certain firms employ more real and tangible property relative to other productive factors than other firms. Some firms can reduce inventories to accommodate tax assessment calendars, and others can not. Add to these obvious shortcomings the facts that industrial and commercial real and personal properties are almost impossible to assess in any uniform fashion and that the levy represents a fixed cost that must be borne irrespective of the profitability of the firm or even its volume of activity, there is ample justification for restructuring the Iowa business tax system. In short, it is not the <u>level</u> of business taxes in Iowa that is irritating but the <u>structure</u>. To the extent that a more attractive business tax structure will contribute to an even more rapid economic growth rate, reliance must be placed on sources other than the property tax—sources that take into account the individual firm's capacity to contribute to the support of government.

The present corporate net income tax could serve as the vehicle for an improved business tax system, but not without revision. As presently constituted, it reaches only a small portion of the corporate net income originating in the State. And what net income is subject to tax is primarily of firms with extensive intra-state operations. Because of the deduction of federal income taxes and the single-factor sales allocation formula, firms with equal sales and net profit pay widely differing tax bills simply because of the destination of their sales. If the sales are to out-of-state destinations, the entire income from such sales is exempt. It would seem difficult to defend the position that the benefits derived from the public services provided to business or the capacity or willingness of firms to support these services is a function solely of the destination of their sales. Yet, the present statute provides for just such an illogical rationale.

The conversion of the Iowa corporate income tax levy into a more reasonable and effective component of the business tax system could be accomplished simply by adopting a two or three factor formula with property and payrolls or property, payrolls, and sales weighted equally in place of the present single factor (See Appendix A). In addition to the elimination of the gross unneutralities under the existing statute, the tax at the current rate and coverage would generate estimated additional revenue ranging from $4-8 million annually.

Replacement of the present corporate net income tax and/or local tax on business personalty with a general business tax on gross margins or value added (that is, gross receipts less purchases from other businesses) has several advantages. It would apply to all businesses, corporate and unincorporated enterprises, thereby removing the discrimination against the corporate form of business organization. With only a 1 per cent rate, it would yield upwards of $70 million annually. Perhaps most important, however, the gross margins levy comes closest to distributing its responsibility in a neutral fashion, i. e., irrespective of the firm's input mix. It does not discriminate against the profitable firm as the net income tax does, nor against the use of capital as does the property tax. In this context, the levy might be considered as a replacement measure for both the corporate net income tax and the local tax on business personalty.

VII. REVENUE REVISION GUIDELINES

In the course of the last eight months, since the designation in October of 1965 of the organizational framework to carry out the directives of HJR 28, considerable time has been devoted to the development of operational objectives or guidelines to be sought in the reform of Iowa's State and local tax structure. The fact that the present structure fails to generate adequate revenues to meet the inevitably rising costs of providing essential public services for an expanding Iowa economy has been demonstrated repeatedly over the past decade by frequent piecemeal adjustments in tax rates and bases. A prime objective, therefore, of the Governor's tax study was the achievement of a tax structure which would produce yields at a rate of growth at least equal to the growth of population and income.

A second and widely recognized deficiency of the Iowa State-local tax structure is its failure to distribute liabilities in accordance with commonly held notions of equity and fairness, that is, in some reasonable relation to the family or individual abilities to pay as measured by relative incomes. Because of the excessive reliance on the local property taxes and on various consumption excises, the distribution of the burden of the tax structure is excessively regressive. Each element of possible adjustment in the existing structure was examined with a view to its impact on reducing the regressivity of the overall tax structure.

Finally, the economic effects of the present structure and of the magnitude of probable repercussions from possible changes in the structure were taken into account. The evaluation of the business tax system centered on the goals of certainty (i.e., the application of business taxes on the basis of clear-cut rules, rather than by negotiation or arbitrary action of public officials) and uniformity, and with due recognition to the fact that Iowa businesses are important beneficiaries of public services.

To sum, the listing in the following section of alternative tax policies contains measures which are directed toward the achievement of the goals of adequacy of revenue, equity, and a continuing business climate conducive to economic expansion. The possibility of surpluses being realized at the close of the current fiscal year renders the need for coordinated tax reform greater than ever because it increases the magnitude of existing inequities and inequalities. It also provides somewhat wider flexibility for tax reform since the pressures for immediate revenue increases are relaxed.

A final word relating to revenue research seems in order. Iowa governments continually require information about their revenue systems. Effective tax administration and forward fiscal planning go hand in hand with the ready availability of such information. At the present time, there are serious informational gaps which must and only can be closed by establishing the machinery to do adequate revenue research and planning and acquiring additional professional personnel to accomplish the assigned tasks. One illustration may suffice to suggest the seriousness of the present situation. There are no available detailed statistics on the distribution of State-local tax liabilities of Iowa businesses by type of business. High priority should, therefore, be given to providing continuing data collection, analysis, and appraisal of the revenue system.

VIII. ALTERNATIVE TAX POLICIES

The projections of Iowa State-local revenues and expenditures indicated that the existing tax structure will not provide the revenues that are likely to be required in the decade ahead. The magnitude of the revenue problem, however, depends as much on this projected budget imbalance as on the decision taken with respect to the local property tax. If reliance on this major obstruction to the achievement of equity and economic growth is to be reduced, replacement revenues will also have to be provided. And at the same time that new revenues are generated, every effort must be made to continue to manage the multi-faceted operations of State-local governments efficiently and economically, and thereby keeping the cost of Iowa governments at the lowest possible level consistent with the attainment of policy objectives.

Depending on the magnitude of the revenue problem, there are a number of alternatives that offer promise as means to achieve the prescribed revenue revision criteria. They can be considered separately or in reasonable combination. Each is intended to enhance revenue productivity, equity and the tax climate for business.

The following summarizes the estimated annual increases and decreases in revenue of each tax adjustment:

Tax Adjustment	Net Increase (Decrease) in Tax Yield (In millions of current dollars)
1. PERSONAL INCOME TAX:	
a) Eliminate deductibility of federal income tax paid ..	15
2. SALES AND USE TAXES:	
a) Increase rate to 3%, extend tax base to include selected personal consumer-type services (e.g., auto repair and parking, etc.), and exempt $600 of taxable purchases per person via $9 credit or rebate on personal income tax	45
b) Increase rate to 3% and provide variable credit ranging from $12 to zero	42
c) Extend sales tax base to include selected consumer-type services	19
3. CORPORATE NET INCOME TAX:	
a) Reduce rate to 3%, eliminate federal income tax deductibility, adopt 2-factor (payrolls and property) allocation formula, and impose 1%	

3. a) (Continued)
tax on gross margin or value added as minimum alternative levy (i.e., corporation would compute both taxes and pay the higher of the two) 42

b) Retain present rate and statutory provisions and impose the minimum alternative 1% gross margins tax 34

c) Repeal corporate net income tax and impose 1% gross margin or value added tax on all business enterprises 73

d) Adopt 3-factor allocation formula 9

e) Eliminate federal income tax deductibility 4

4. PROPERTY TAX:

a) Exempt tangible personal property except inventories .... (45)

b) Exempt machinery, equipment, tools, dies, inventories, etc., from local property tax and impose specific State-administered levy only on machinery, inventories and equipment at a rate equal to the average State-wide effective rate on real property 28

c) Exempt household goods .... (5)

APPENDIX A

A BILL FOR

An Act relating to the business tax on corporations.

Be It Enacted by the General Assembly of the State of Iowa:

Section 1. Section four hundred twenty-two point thirty-two (422.32), Code 1966, is amended by adding thereto the following new subsections:

"5. The words 'business income' means income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the corporation's regular trade or business operations.

"6. The words 'commercial domicile' mean the principal place from which the trade or business of the corporation is directed or managed.

"7. The word 'compensation' means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services.

"8. The words 'nonbusiness income' means all income other than business income.

"9. The word 'sales' means all gross receipts of the corporation not allocated under subsections three (3) through seven (7) of section two (2) of this Act.

"10. The word 'state' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States; and any foreign country or political subdivision thereof."

Sec. 2. Section four hundred twenty-two point thirty-three (422.33), Code 1962, as amended by Senate File six hundred five (605), Acts of the Sixty-first General Assembly, is further amended by striking all of such section after the period in line seven (7) and inserting in lieu thereof the following:

"1. Any corporation having income from business activity which is taxable in this state or taxable both within and without this state shall allocate and apportion its net income as provided in this Act.

"2. For purposes of allocation and apportionment of income under this Act, a corporation is taxable in another state if:

a. In that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax.

b. That state has jurisdiction to subject the corporation to a net income tax regardless of whether, in fact, that state does or does not.

"3. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in subsections four (4) through seven) of this section.

"4. Net rents and royalties from real property located in this state are allocable to this state.

b. Net rents and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state.

(2) In their entirety if the corporation's commercial domicile is in this state and the corporation is not organized under the laws of or taxable in the state in which the property is utilized.

c. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the corporation, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

"5. a. Capital gains and losses from sales of real property located in this state are allocable to this state.

b. Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale.

(2) The corporation's commercial domicile is in this state and the corporation is not taxable in the state in which the property had a situs.

c. Capital gains and losses from sales of intangible personal property are allocable to this state if the corporation's commercial domicile is in this state.

"6. Interest and dividends are allocable to this state if the corporation's commercial domicile is in this state.

"7. a. Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor of such patent and copyright royalties in this state.

(2) If and to the extent that the patent or copyright is utilized by the payor in a state in which the corporation is not taxable and the corporation's commercial domicile is in this state.

b. A patent is utilized in a state to the extent that it is employed in production fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the corporation's commercial domicile is located.

c. A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the corporation's commercial domicile is located.

"8. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3).

"9. The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the tax period.

"10. Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight (8) times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from sub-rentals of rented property or like or similar property.

"11. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the tax commission may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the corporation's property.

"12. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the corporation for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

"13. Compensation is paid in this state if:

a. The individual's service is performed entirely within the state.

b. The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state.

c. Some of the service is performed in the state and (1) the base of operations, or, if there is no base of operations, the place from which the service is directed or controlled in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

"14. The sales factor is a fraction, the numerator of which is the total sales of the corporation in this state during the tax period, and the denominator of which is the total sales of the corporation everywhere during the tax period.

"15. Sales of tangible personal property are in this state if:

a. The property is delivered or shipped to a purchaser, other than the United States government, within the state regardless of the f.o.b. point or other conditions of the sale.

b. The property is shipped from an office, state, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the corporation is not taxable in the state of the purchaser.

"16. Sales, other than sales of tangible personal property, are in this state if:

a. The income-producing activity is performed in this state.

b. The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

"17. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the corporation's business activity in this state, the corporation may petition for or the tax commission may require, in respect to all or any part of the corporation's business activity, if reasonable:

a. Separate accounting.

b. The exclusion of any one (1) or more of the factors.

c. The inclusion of one (1) or more additional factors which will fairly represent the corporation's business activity in this state.

d. The employment of any other method to effectuate an equitable allocation and apportionment of the corporation's income."

EXPLANATION

The purpose of this Act is to replace the present corporation tax with a corporation tax based on the three-factor formula, in conformity with the uniform legislation proposed by the National Conference of Commissioners on Uniform State Laws.

A BILL FOR

An Act relating to the personal income tax.

Be It Enacted by the General Assembly of the State of Iowa:

Section 1. Section four hundred twenty-two point four (422.4), Code 1966, is amended by putting a period at the end of line eleven (11) and striking lines twelve (12) and thirteen (13).

Sec. 2. Section four hundred twenty-two point nine, (422.9), Code 1966, is amended by striking all of part b, subsection two (2) and inserting in lieu thereof the following:

"b. Where a taxpayer has used an optional standard deduction on his federal return, he shall use the optional standard deduction provided for above."

APPENDIX C

A BILL FOR

An Act relating to the corporation income tax.

Be It Enacted by the General Assembly of the State of Iowa:

Section 1. Section four hundred twenty-two point thirty-five (422.35), Code 1966, is amended by striking all of subsection four (4).

Sec. 2. Section four hundred twenty-two point thirty-five (422.35), Code 1966, is amended by striking lines twenty-nine (29) through thirty (30) of subsection five (5)."

APPENDIX D

A BILL FOR

An Act relating to sales tax.

Be It Enacted by the General Assembly of the State of Iowa:

Section 1. Section four hundred twenty-two point forty-three (422.43), Code 1966, is amended by inserting the following new paragraph after the fourth (4th) paragraph thereof:

"There is hereby imposed a like rate of tax upon the gross receipts from the services rendered or performed by barber shops, beauty shops, beauty parlors, cleaning, dyeing, pressing shops, linen, coat, apron, uniform and overall supply service, and laundries in a private home."