

*Iowa's State  
Budget:  
Spending  
Our Way to a  
Crisis  
Revised Version*

by  
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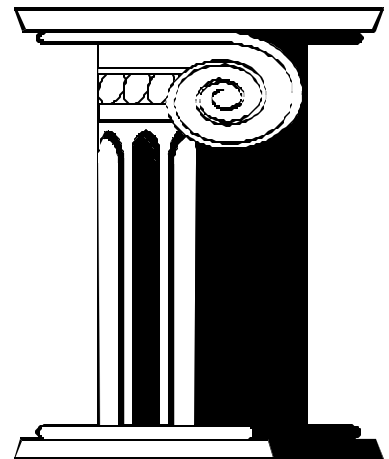
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# *Iowa's State Budget: Spending Our Way to a Crisis*

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*Iowa's State Budget:  
Spending Our Way to a Crisis - Revised Version*

**Authors' Note:**

The revised version of this policy study contains updated numbers for Fiscal Year 2003. All numbers, tables, and figures have been changed to reflect the new numbers for the FY 2003 Iowa Budget

**Executive Summary:**

The state of Iowa has faced a budget crisis for more than a year. One cause of this crisis that has not received proper attention is spending. This is a major oversight because in the first two fiscal years of the Vilsack Administration, the state went on a spending binge. Total state spending, excluding federal funds, increased more than \$434 million between FY 1999 – FY 2001. That is a total increase of 8.6%.

This increase was not at all necessary. The average spending increase of the first two Vilsack budgets was 4.23%. That is more than twice the rate of inflation and nine times the rate of Iowa population growth for that same period. Had spending been held to increases for inflation and population growth from FY 1999 – FY 2001, the state of Iowa would have been saved more than \$359 million.

However, Governor Vilsack, with the acquiescence of the State Legislature, did not limit spending from FY 1999 – FY 2001. As a result, the state budget was bloated with excess spending, setting Iowa up for a crisis when revenues began to decline in 2001.

The state is continuing to experience budget problems in the current fiscal year. State revenue collections may not match the funding levels in the FY 2003 budget. In the short term, State Legislators and the Governor should consider an across-the-board cut in General Fund spending. But this is only a temporary solution. If our state's budget health is to be preserved in the long run, Constitutional limits must be adopted that would place fair and reasonable limits on the growth of the state budget.

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# *Iowa's State Budget: Spending Our Way to a Crisis: Policy Study*

*“By overspending when the state was awash in revenue, the Governor and State Legislature set us up for severe budget problems when the revenue streams dried up.”*

## *Iowa's State Budget: Spending Our Way to a Crisis*

### **INTRODUCTION**

The state of Iowa has faced a budget crisis for more than a year. In January 2001 it became clear that state government revenues were going to fall short of expenditures. The deficit would become the largest that Iowa had seen in years. Although the State Legislature made early attempts to deal with this shortfall, Governor Tom Vilsack did not act until Fiscal Year 2001 ended. Since then Governor Vilsack has twice called the State Legislature into a special session. Despite these efforts, the prognosis for the coming year is not good.

What is the cause of the Iowa budget crisis? Some have argued that the culprit is tax cuts, and others have blamed the economic recession. One cause that has not received proper attention is spending. This is a major oversight because in the first two fiscal years under the Vilsack Administration, the state went on a spending binge. Governor Vilsack and the State Legislature increased total state spending between Fiscal Years 1999 and 2001 by more than \$434 million, an increase of 8.6%. By overspending when the state was awash in revenue, the Governor and State Legislature set us up for severe budget problems when the revenue streams dried up.

The response to the budget crisis has been fiscally

irresponsible. To address the crisis, the Governor and State Legislature have:

- Cut spending by only \$203 million.
- Drained the Rainy Day Fund by more than 60%.
- Transferred more than \$400 million from special budget “funds” to make up for revenue shortfalls.

In short, the Governor and the State Legislature have left Iowa in bad fiscal shape if the budget crisis should continue.

Who should bear the bulk of the blame for the budget crisis, the Governor or the State Legislature? Certainly, the State Legislature must share in the blame. It did not rein in the spending increases in the Governor's proposed budgets in Fiscal Years 2000 and 2001. It has also acquiesced in the gimmicks used to shore up revenue shortfalls in the budget. The State Legislature has not done its job of ensuring that the Governor engages in responsible fiscal management.

Yet the largest share of the blame lies at the feet of Governor Vilsack. It is the Governor who sets the parameters of the budget process in Iowa. According to Iowa law, the Governor is charged with “initiation and

preparation of a balanced budget.”<sup>1</sup> He must submit that budget, along with a “budget message,” to the legislature no later than February 1<sup>st</sup> of each year.<sup>2</sup> He is responsible for the “direct and effective financial supervision over all departments and establishments.”<sup>3</sup> He also has the power to veto specific spending items from appropriation bills.<sup>4</sup> The responsibility for the state budget lies heavily on the shoulders of any Governor; so does the responsibility for a budget crisis.

The remainder of this study is divided into four parts. First, it traces the history of the budget process during the Vilsack Administration. Second, it examines the question of whether the budget crisis is the result of tax cuts. Third, it examines the spending side of the budget equation. Finally, it proposes solutions for both alleviating the present budget crisis, and avoiding future crises.

## **BUDGET HISTORY**

When Iowa’s Governor Vilsack took office in January 1999, he took advantage of what were then good economic times to propose numerous increases in state spending. When the good times came to an end, he was slow to heed the warnings that revenue was declining. The State Legislature seems more fiscally prudent than the Governor, but more often than not ends up meeting him at least “halfway,” resulting in increased state spending.

One of Governor Vilsack’s proposals early in his term was a \$150 million increase in funding for his education program, including a reduction in class size. His plan called for a five-year commitment, spending \$10 million in the first year, and increasing that amount by \$10 million each year, up to \$50 million in the fifth year of the program.<sup>5</sup> The leadership in the Iowa House and Senate expressed their concerns about making a large spending commitment for future Legislatures. Then-Speaker Ron Corbett said, “Automatic spending by the Legislature was part of the reason for the budget crisis in the early 1990s.”<sup>6</sup> But the Governor dismissed their concerns, accusing them of putting tax cuts before education improvements.

Governor Vilsack proposed a FY 2000 budget that included \$275 million in new spending.<sup>7</sup> The State Legislature in turn proposed budget targets that increased spending by \$192 million, a 4.25% increase from FY 1999 spending, bringing General Fund spending to \$4.6 billion.<sup>8</sup> According to Senate Majority Leader Iverson, “The state will already spend more than it takes in this year at 4.25%.”<sup>9</sup> In the end, the Governor and Legislature compromised by spending an additional \$260 million in FY 2000, an amount closer to the Governor’s original proposal.<sup>10</sup>

In September 1999, Budget Director Randy Bauer cautioned that the combination of spending increases and declining state

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*“As the year progressed, it became clear that the Governor’s balanced budget plan included spending up to \$120 million of the Emergency Economic Fund and transfers from other funds.”*

revenue had reduced the surplus, and that spending should decrease if revenue did not increase.<sup>11</sup>

By the middle of FY 2001, State Legislators recognized that Iowa had a budget problem, and needed to reduce spending. Republican Legislators proposed a de-appropriation bill to reduce current-year spending by \$40 million, pointing to state receipts that were \$170 million below the estimate on which the budget was based.<sup>12</sup> The proposal identified areas that would not be cut, such as government schools, prisons, health care for the poor, and the Veterans’ Home. Governor Vilsack responded that the Legislature was overreacting and that such cuts were not warranted at that time.<sup>13</sup>

The Legislature ultimately passed a bill to cut \$25 million from the current year budget; however, the Governor line-item vetoed all but \$8.5 million of the cuts.<sup>14</sup> The following day, Governor Vilsack proposed changes to the teacher compensation system, at a cost of \$250 to \$300 million over the next four years.<sup>15</sup>

In March 2001 the Revenue Estimating Council revised its budget estimates to reflect much lower state revenues, reducing estimated growth from 3.5 percent to 0.7 percent for FY 2001 and from 4.8 percent to 4.3 percent for FY 2002.<sup>16</sup> In response, Governor Vilsack had to submit a new budget proposal for FY 2002. The Department of Management estimated the Governor needed to reduce his

budget by \$285 million.<sup>17</sup> The Governor attempted to meet this goal in part by proposing to spend \$120 million from the Economic Emergency Fund and shifting some gambling revenue from the Rebuild Iowa Infrastructure Fund to the General Fund.<sup>18</sup>

In January of this year, Governor Vilsack touted his Administration’s strong fiscal management of the state budget, promising a balanced budget with a surplus of \$400 million including the reserve funds.<sup>19</sup> However, as the year progressed, it became clear that the Governor’s balanced budget plan included spending up to \$120 million of the Economic Emergency Fund and transfers from other funds, such as the Road Use Tax Fund (RUTF), to the General Fund.<sup>20</sup>

In May, the Revenue Estimating Council again reduced its budget estimates for FY 2002 and FY 2003, resulting in a shortfall of over \$200 million in each of those fiscal years.<sup>21</sup> In a Special Session that month, the State Legislature and the Governor reached an agreement on the budget, using funds from the Economic Emergency Fund, the Cash Reserve Fund, and other sources to cover the shortfall for FY 2002.<sup>22</sup> The Legislature did reject the Governor’s call to take funds from the RUTF, which were intended to be used for road construction projects, for other programs.

Governor Vilsack and the Legislature increased state spending in the early years of

Vilsack’s term, and when the economy began its decline, Vilsack in particular was slow to recognize the budgetary problems facing the state of Iowa.

## TAX CUTS

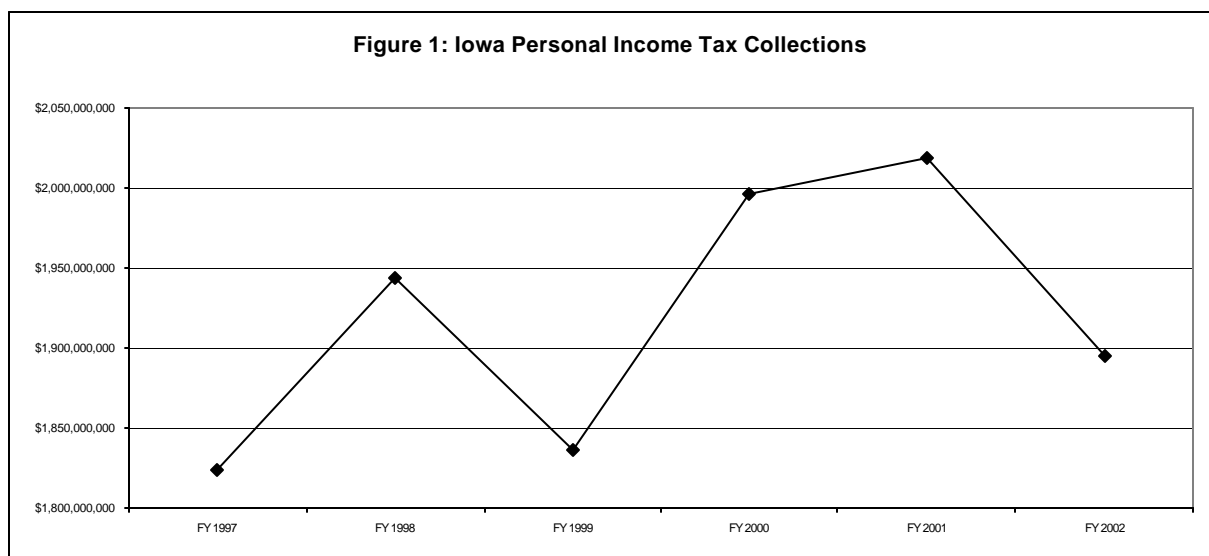
One explanation for the sudden budget shortfall focuses on the state tax cuts of the late 1990s. According to this argument, the tax cuts have reduced the amount of revenue that has come into the state. Had those taxes been in place, Iowa would have had enough revenue to avoid much of the budget crisis. For example, in a May 12, 2002 editorial, the *Des Moines Register* (DMR) voiced its disapproval of the 1998 income-tax cut: “On the revenue side, what is costing the state the most is the 10 percent across-the-board income-tax cut in 1998.”<sup>23</sup> The editorial also criticized other tax cuts such as cuts in capital gains rates. The DMR claimed

that the result of these tax cuts was that “For fiscal year 2002 alone . . . Iowa’s treasury will have foregone \$844 million, according to the Department of Management.”

First, it should be noted that until the recession of 2001, tax collections in Iowa were still solid despite any tax cuts. For example, Figure 1 shows that except for FY 1999 Iowa’s personal income tax collections continued to grow even after the tax cut. As would be expected, the year after the income-tax cuts went into affect, there was a drop in income-tax collections. However, the years following FY 1999 saw an increase in tax collection when compared to levels prior to FY 1999. Furthermore, as Figure 2 shows, both personal income tax collections and total tax collections increased during the first two years of the Vilsack Administration, by \$182 million and \$194 million, respectively.

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*“Until the recession of 2001, tax collections in Iowa were still solid despite any tax cuts.”*



*Source: Public Interest Institute Analysis of Iowa Department of Revenue and Finance and Iowa Legislative Fiscal Bureau Data*

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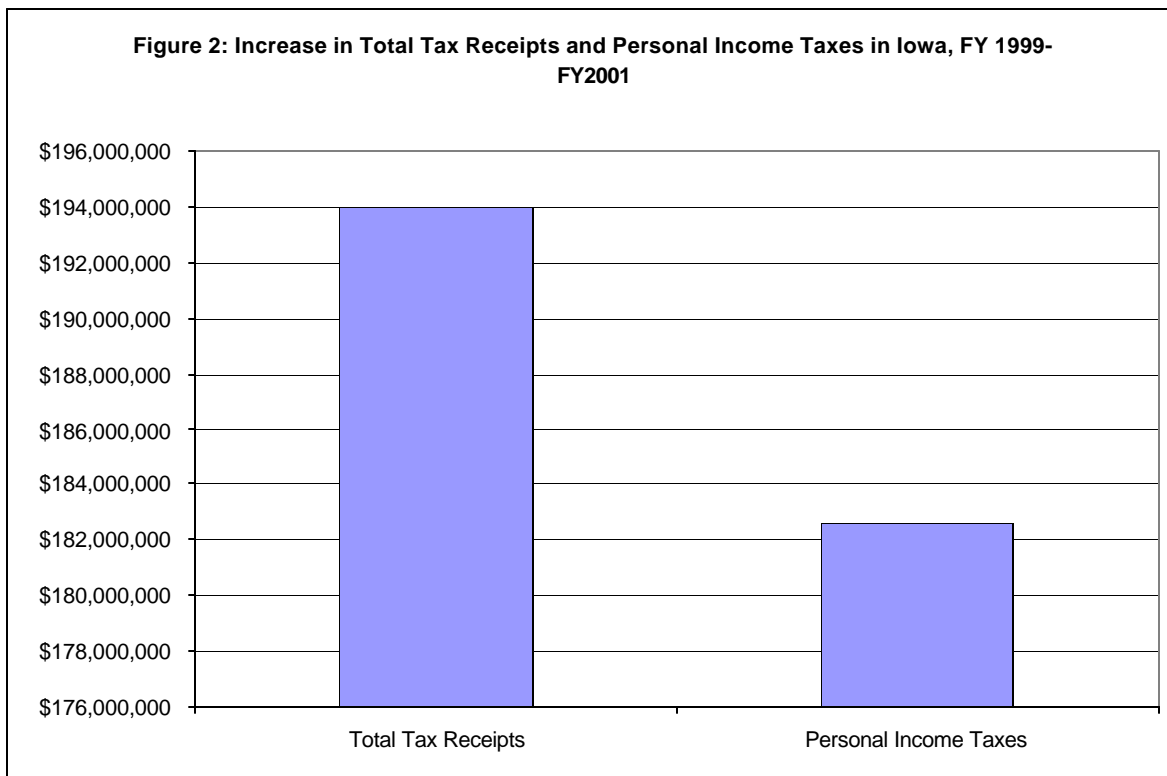
That should have been more than sufficient to meet state funding needs.

The main problem with the numbers from the Department of Management cited by the DMR is that they are based on static analysis. Static analysis assumes that taxes have no effect on economic activity. In the case of Iowa, it assumes that the economic activity from 1998-2001, and the resulting rise in personal income, would have been the same regardless of the tax rate.

On the other hand, dynamic analysis assumes that tax rates do affect economic activity. It assumes that higher tax rates result in fewer income-producing

activities like creating new businesses and investing. This study performed a dynamic analysis on recent tax and income data in Iowa. (See Appendix 4 for the methodology.) What this analysis found was that state personal income would have been \$856 million lower in FY 2001 if state personal-income taxes had been 10% higher. The resulting increase in personal-income tax revenue would have been only \$622 thousand. Thus, without the income-tax cut of 1998, Iowa income growth would have been much slower and income-tax collections would have been only slightly higher in subsequent years.

It is suspect, at best, to blame the tax cuts of the 1990s for the



Source: Public Interest Institute Analysis of Iowa Department of Revenue and Finance and Iowa Legislative Fiscal Bureau Data

current budget crisis. The explanation must be sought elsewhere. That is the subject of the next section.

## SPENDING

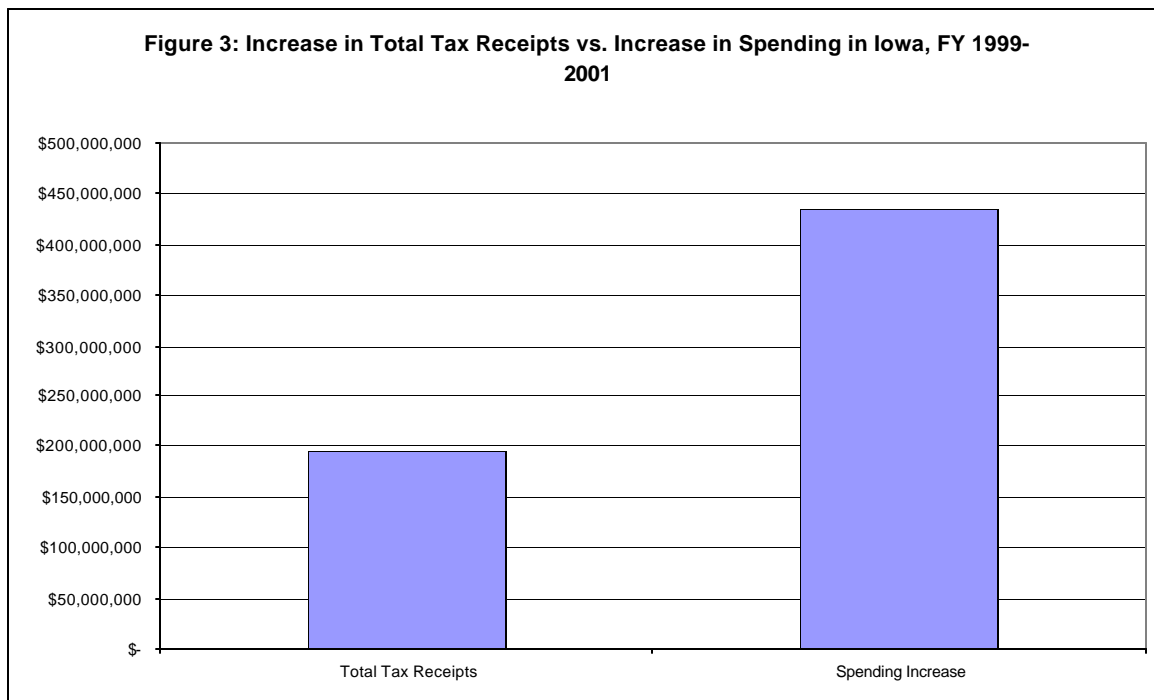
Since the root of Iowa's budget problem is not insufficient tax revenue, the question remains what is the source of the budget problem? This section examines the spending side of the Iowa budget. Specifically, it examines trends in state government spending from FY 1999, the year before Governor Vilsack submitted his first budget, to FY 2003, the year of Vilsack's most recent budget. It is divided into three sub-sections: general spending trends, General Fund vs. Non-General Fund, and spending on specific budget functions.

Unless otherwise noted, all spending examined here is a combination of both the General Fund and Non-General Fund, minus funding from the Federal Government.

### General Spending Trends

The first indication that the budget problem is spending-induced is evident in Figure 3, which compares total tax receipts and spending increases from FY 1999 to FY 2001. Although the *Des Moines Register* blames the budget problem partially on lack of personal income tax revenue, Figure 3 shows that tax revenue grew more than \$194 million between FY 1999 – FY 2001. During that same time period, total state spending increased just over \$434 million. State spending

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Source: *Public Interest Institute Analysis of Iowa Department of Revenue and Finance and Iowa Legislative Fiscal Bureau Data*

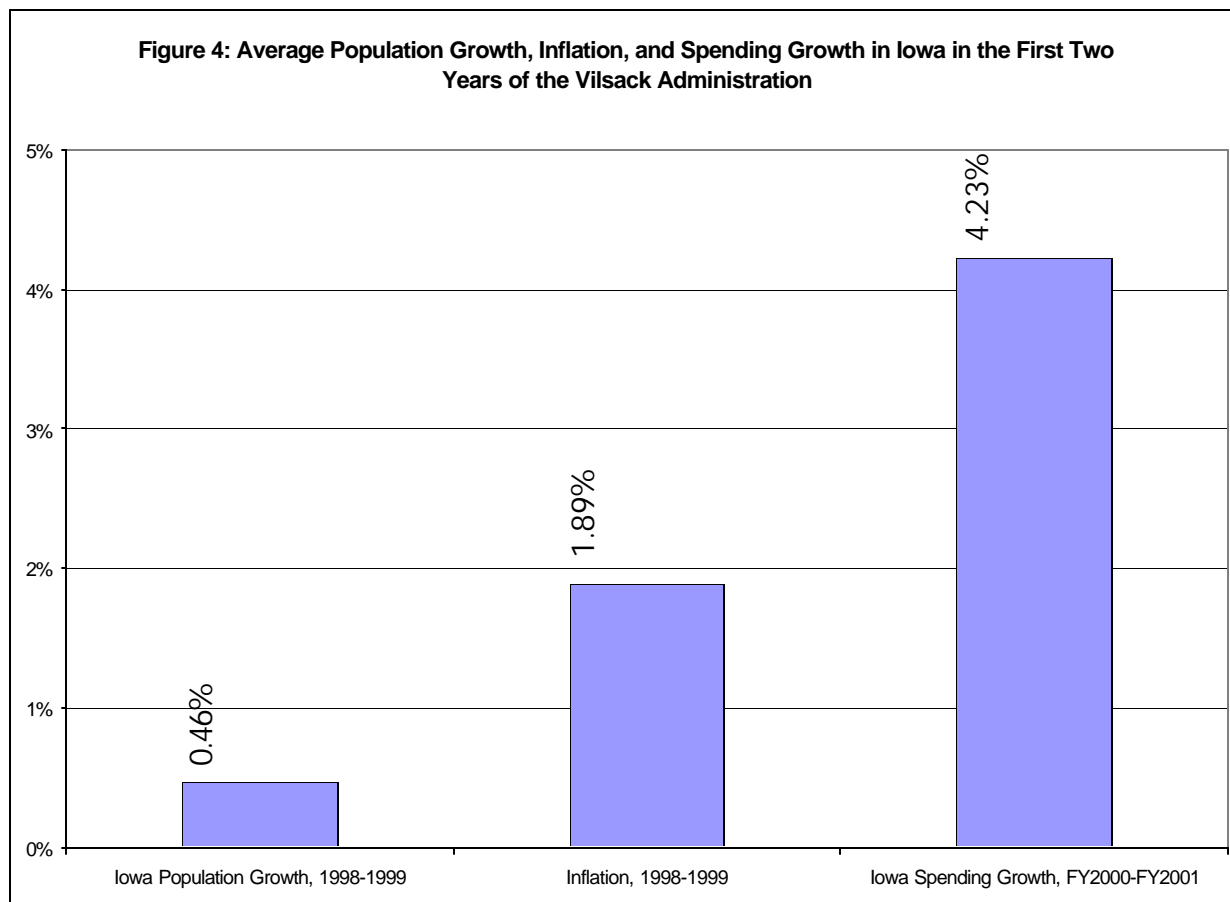
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during the first two years of the Vilsack Administration grew 223% faster than tax revenue!

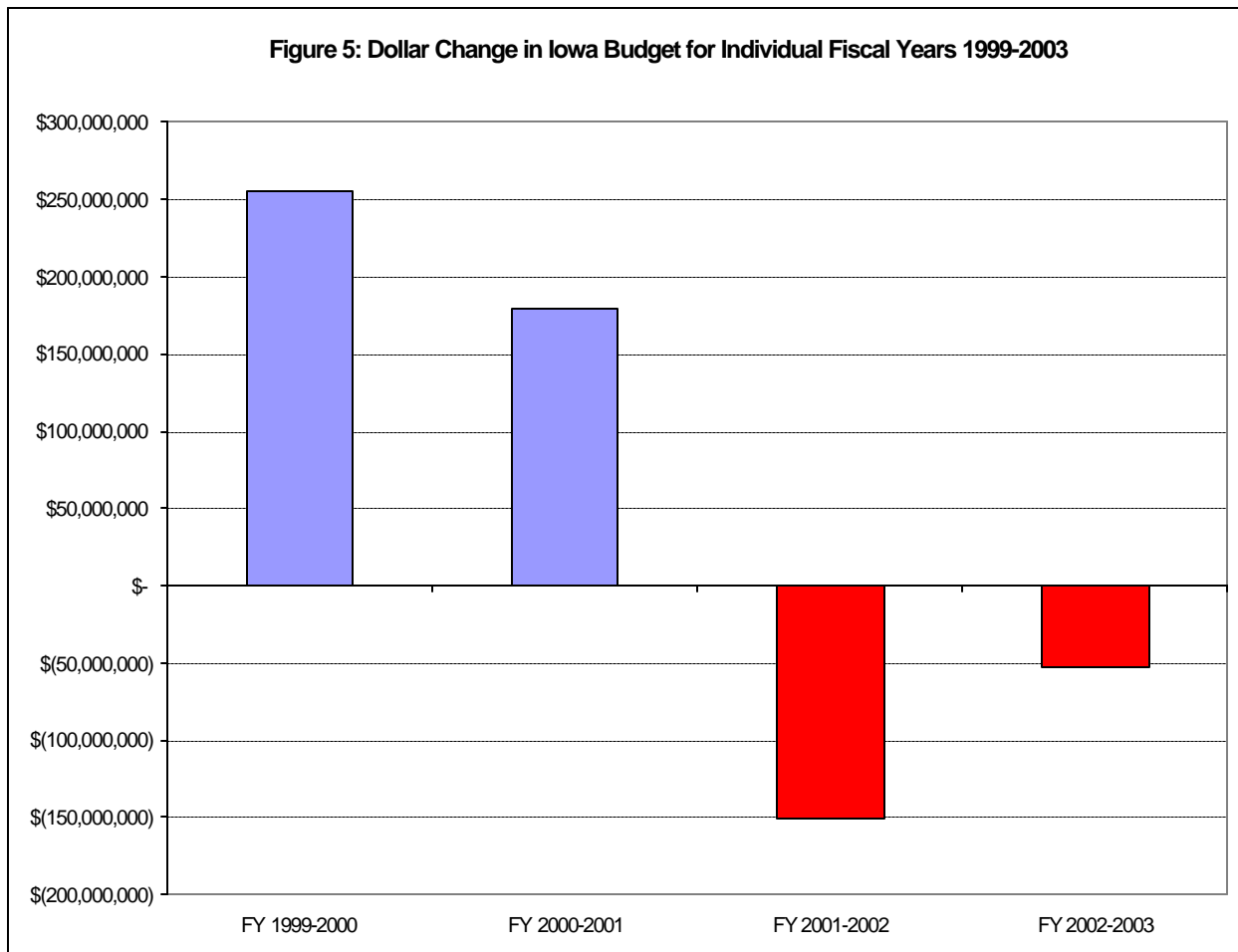
This increase in spending was not at all necessary. Figure 4 examines population growth and inflation in each year prior to each of Vilsack's first two budgets and compares them with the spending increase in those first two budgets. The average increase in population in Iowa in the years 1998 and 1999 was 0.46%. The average inflation rate for that same time period is 1.89%. The average increase in spending for Vilsack's first two budgets was 4.23%. That is more than two times faster than the inflation rate,

and more than nine times faster than the rate of population growth in Iowa. In short, the spending increases far outpaced inflation or population-growth pressures on the state budget.

Spending increases in FY 2000 and FY 2001 also dwarfed the spending cuts in FY 2002 and FY 2003. The evidence of this is presented in Figure 5, which displays the dollar changes in the state budget over the last four fiscal years. It shows that the spending cuts of the last two fiscal years are much smaller than the spending increases in the first two fiscal years under the Vilsack Administration. The total dollar



Source: Public Interest Institute Analysis of Bureau of Labor, Bureau of Economic Analysis, and Iowa Legislative Fiscal Bureau Data



*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

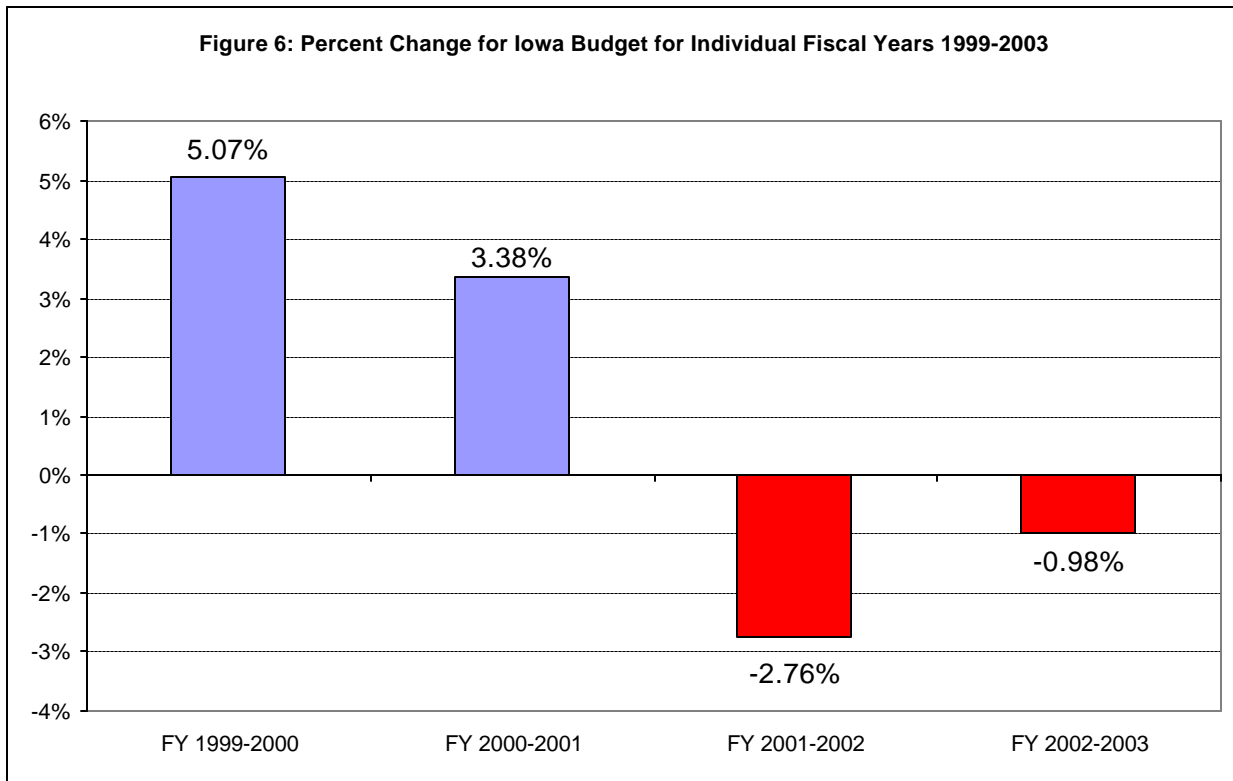
amount for the spending increases in FY 2000 and FY 2001 is \$434,288,587. By contrast, the total dollar amount for the spending decreases in the FY 2002 and FY 2003 is \$203,257,911. Thus, the total dollar amount for the spending increases is a huge 213% larger than the total dollar amount for the spending decreases.

The next evidence that the increases dwarfed the cuts is presented in Figure 6, which displays the percent change in the budget in each fiscal year. The percent of spending cuts from FY 2001 – FY 2003 is considerably

smaller than the percent of spending increases from FY 1999 – FY 2001.

It is also important to note that much of the current budget crisis has not been addressed through spending cuts, but through a transfer of money from smaller state funds, such as the Environment First Fund, Terminal Health Liability Fund, and the Rainy Day Fund. Table 1 shows how much of each fund has been transferred to the General Fund in recent fiscal years. In FY 1998, the year before Governor Vilsack’s first budget, only four such funds were used in this

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*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

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manner. By FY 2002, 23 funds were used in this manner. The dollar amount of such transfers increased from just over \$40 million in FY 1998 to more than \$300 million in 2002. Of that amount in FY 2002, \$195 million was transferred out of the Rainy Day Fund. Due to such transfers continuing in FY 2003, the Rainy Day Fund has gone from having \$485.8 million in February 2001, to \$165.2 million today, a decline of nearly two-thirds.<sup>24</sup>

This is all the more troubling when one considers the condition of state finances had spending in Vilsack's first two years been limited to increases in inflation and population growth. Indeed, the state would have saved \$359 million which could have been stored away for the future. This

would have done much to alleviate the present budget crisis. Instead, the profligate spending of Vilsack's first two years has resulted in a heavily depleted Rainy Day Fund. As a result, Iowa will face serious fiscal trouble if the budget crisis continues.

## **General Fund vs. Non-General Fund**

Another budget trend that has been exacerbated under Governor Vilsack is growth of the Non-General Fund. There are two basic portions of the Iowa budget, the General Fund and the Non-General Fund. The General Fund is one budget fund that has many limits and controls imposed on it by Iowa law. By contrast,

**Table 1: Various Budget Funds Transferred to the General Fund, FY 1998 – FY 2002**

Fund	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
Rainy Day Fund					\$ 195,000,000
Brucellosis					\$ 1,000,000
TRANS Retirement Funds					\$ 2,314,463
Strategic Investment Fund					\$ 1,000,000
Value-Added Ag Fund					\$ 500,000
Pooled Technology Fund					\$ 700,000
Reversion Incentive Fund			\$ 400,986		
Vehicle Depreciation Fund					\$ 2,200,000
Mental Health Prop Fund					\$ 1,500,000
Enhanced Court Collections				\$ 4,000,000	
Workforce Attrition Fund					\$ 1,425,963
Innovations Fund			\$ 300,000		
Environment First Fund					\$ 4,700,000
Recreational Trails					\$ 5,500,000
Groundwater Fund					\$ 4,200,000
Other		\$ (8,049)			\$ 2,800,000
Highway Patrol Appropriation			\$ 1,035,650		
Regents Infrastructure					\$ 7,000,000
ISU Livestock					\$ 2,797,000
Marine Fuel Tax	\$ 2,525,434	\$ 1,108,194	\$ 411,311	\$ 411,311	\$ 411,311
Indirect Cost	\$ 2,074,561	\$ 2,075,339	\$ 2,360,349	\$ 3,070,819	\$ 2,340,519
Terminal Health Liability Fund					\$ 133,000
Lottery	\$ 34,219,195	\$ 35,270,151	\$37,050,570	\$ 34,309,653	\$ 39,994,103
Aviation					\$ 360,000
Tobacco Funds				\$ 64,600,000	\$ 6,000,000
Endowment for Healthy Iowa					\$ 22,000,000
Prison Infrastructure Fund	\$ 1,303,191	\$ 326,551		\$ 2,153,768	\$ 1,894,367
<b>Total</b>	<b>\$ 40,122,380</b>	<b>\$ 38,772,186</b>	<b>\$41,558,866</b>	<b>\$108,545,551</b>	<b>\$ 305,770,727</b>

Source: Iowa Legislative Fiscal Bureau Data

the Non-General Fund is composed of many different funds, including the Road Use Tax Fund, the Rebuild Iowa Infrastructure Fund, and the Tobacco Fund. Iowa law puts fewer restrictions on the Non-General Fund. For example, many Iowans are under the mistaken impression that the state law which limits spending to 99% of revenues applies to the entire Iowa budget. In fact, it applies only to the General Fund.<sup>25</sup> Thus, Iowa Legislators can evade the spending limitations by increasing

state spending in the Non-General Fund. In the past few years, that is exactly what has happened.

This is confirmed in Figure 7 which displays the percent increase in spending in both the General and Non-General funds from FY1999 – FY2003. Due to spending limits and budget cuts, growth in the General Fund has declined -1.35% over this period. But during the same period, the Non-General Fund has increased more than 49%.

Figure 8 brings even starker detail to this trend. It shows the

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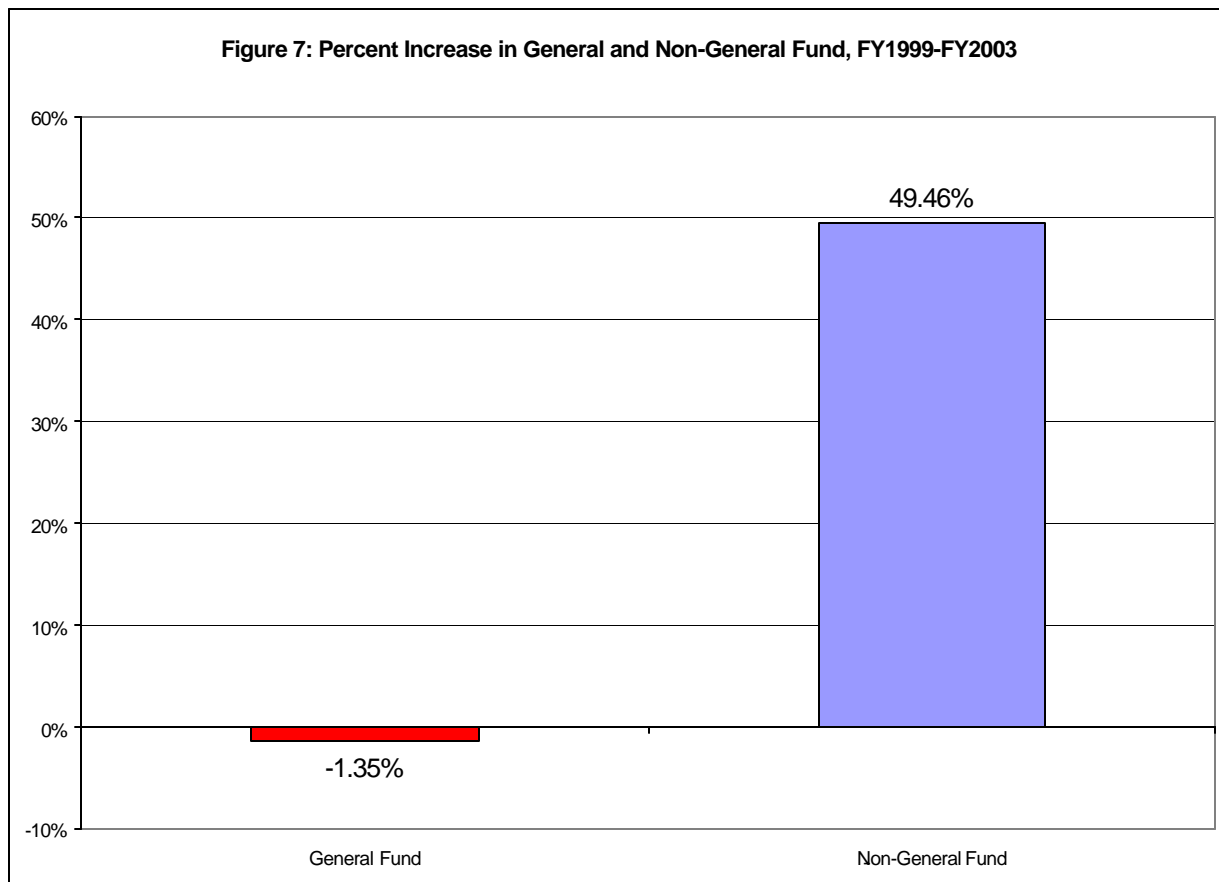
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percent changes between Fiscal Years for both the General Fund and Non-General Fund. The divergence in spending patterns begins in FY 2000 – FY 2001, during which the General Fund spending rose about 2.6%, and the Non-General Fund spending rose more than 10%. During the FY 2001 – FY 2002 period the Non-General Fund rose more than 21% while General Fund spending was being reduced. Clearly, the increasing preference is to spend through the Non-General Fund.

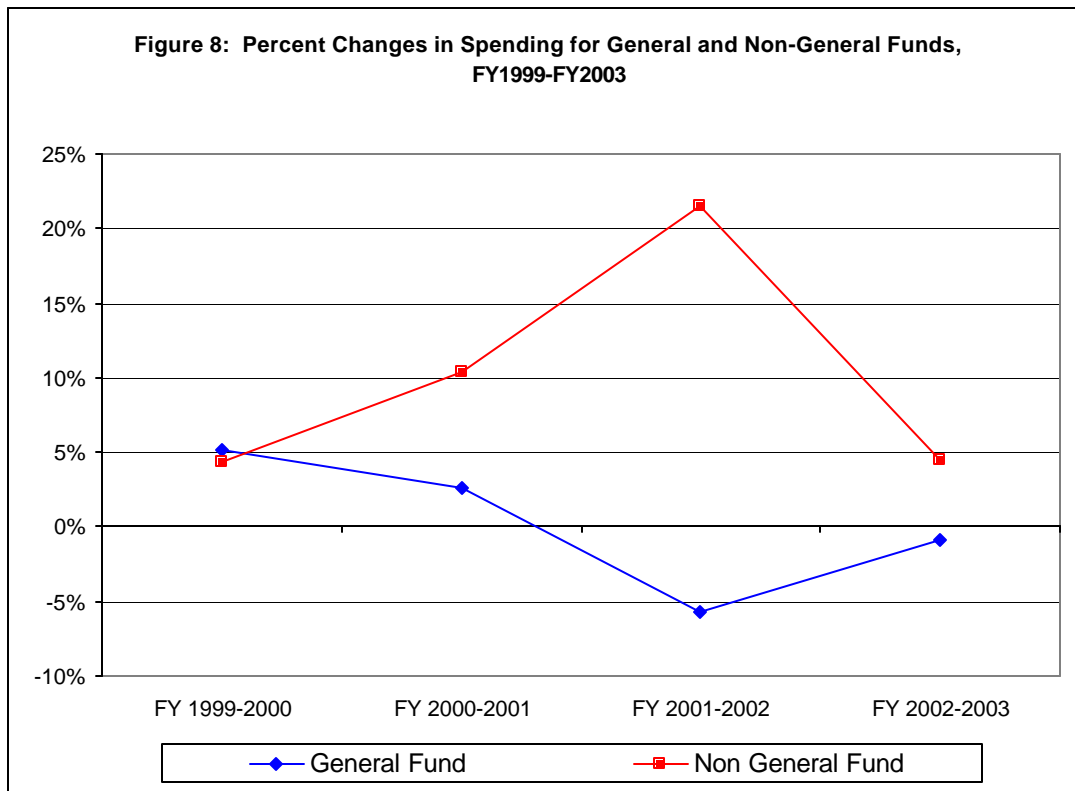
The difference between the General Fund and Non-General Fund was overlooked in a recent report by the National Conference of State Legislatures

(NCLS), leading to an incorrect figure on the amount of budget cuts in Iowa.<sup>26</sup> According to the NCLS, spending from FY 2001 – FY 2002 declined in Iowa by -5.7%. Yet the NCLS only looked at the General Fund. When the increase in funding in the Non-General Fund is factored in, the total decline in spending in the Iowa budget was only -2.76%. Unfortunately, the NCLS report has enabled the Vilsack reelection campaign to portray Vilsack's action on the budget crisis as stronger than it actually has been.<sup>27</sup>

Finally, Figure 8 also shows that the budget crisis has, to some extent, caught up to the Non-General Fund in FY 2002 – FY



Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data



*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

2003. The increase for that period, 6.34%, was less than in previous periods. But this is likely temporary. The natural tendency of government is to increase spending. Shifting more of the budget to the Non-General Fund makes it easier for Iowa politicians to increase spending. Unless new spending limits are imposed on the Non-General Fund, the trend seen under Vilsack is likely to continue.

### **Spending on Specific Budget Functions**

This final sub-section on spending examines the spending patterns on specific budget functions. Particularly, it explores

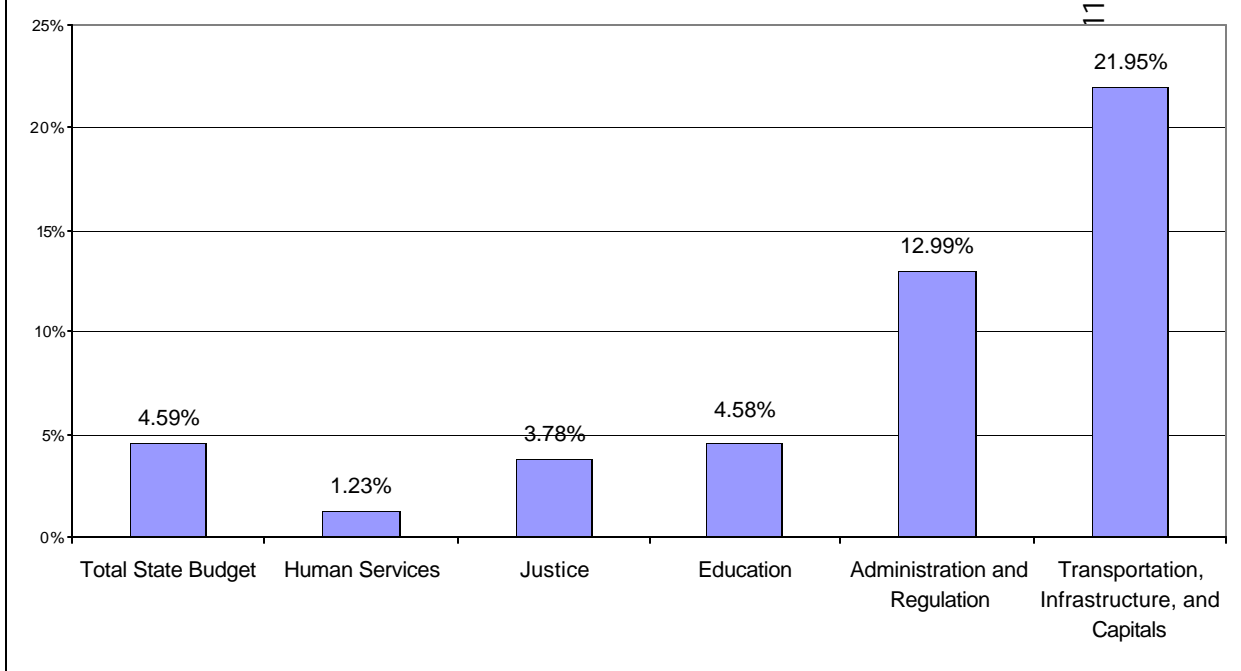
recent spending on Human Services; Education; Administration and Regulation; Justice; and Transportation, Infrastructure, and Capitals.

Figure 9 displays the total percent increase in the Iowa budget and the above-mentioned functions from FY 1999 – FY 2003. The total budget is up 4.59% since FY 1999, meaning that even with recent cuts, state spending is still up over when Vilsack first assumed office.

One area that is still up is Human Services. Figure 10 shows the budget trends in Human Services for FY 1999 – FY 2003. While spending is up only 1.23%, it is still \$10 million above its FY 1999 level. Another area to focus on is Education.

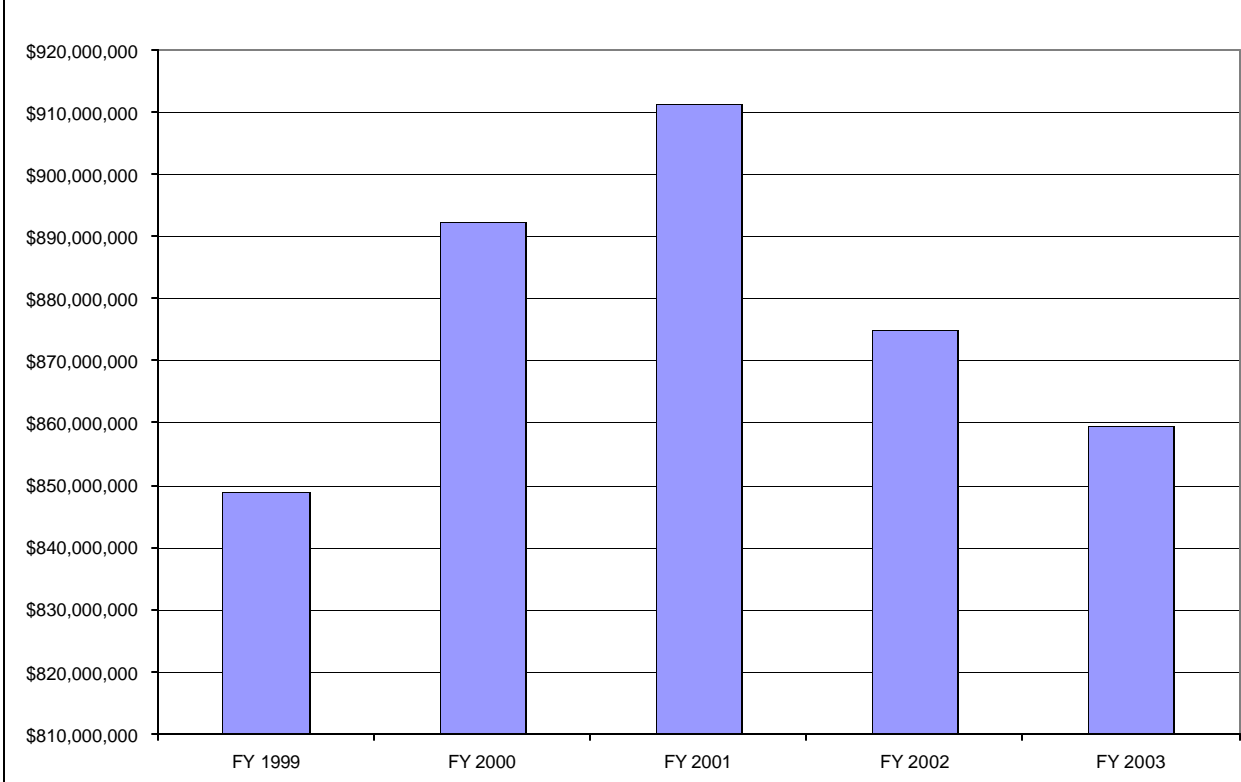
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**Figure 9: Percent Change in Iowa Budget and Various Budget Functions, FY1999-FY2003**



Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data

**Figure 10: Trend in Iowa Human Services Budget, FY 1999 - FY 2003**



Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data

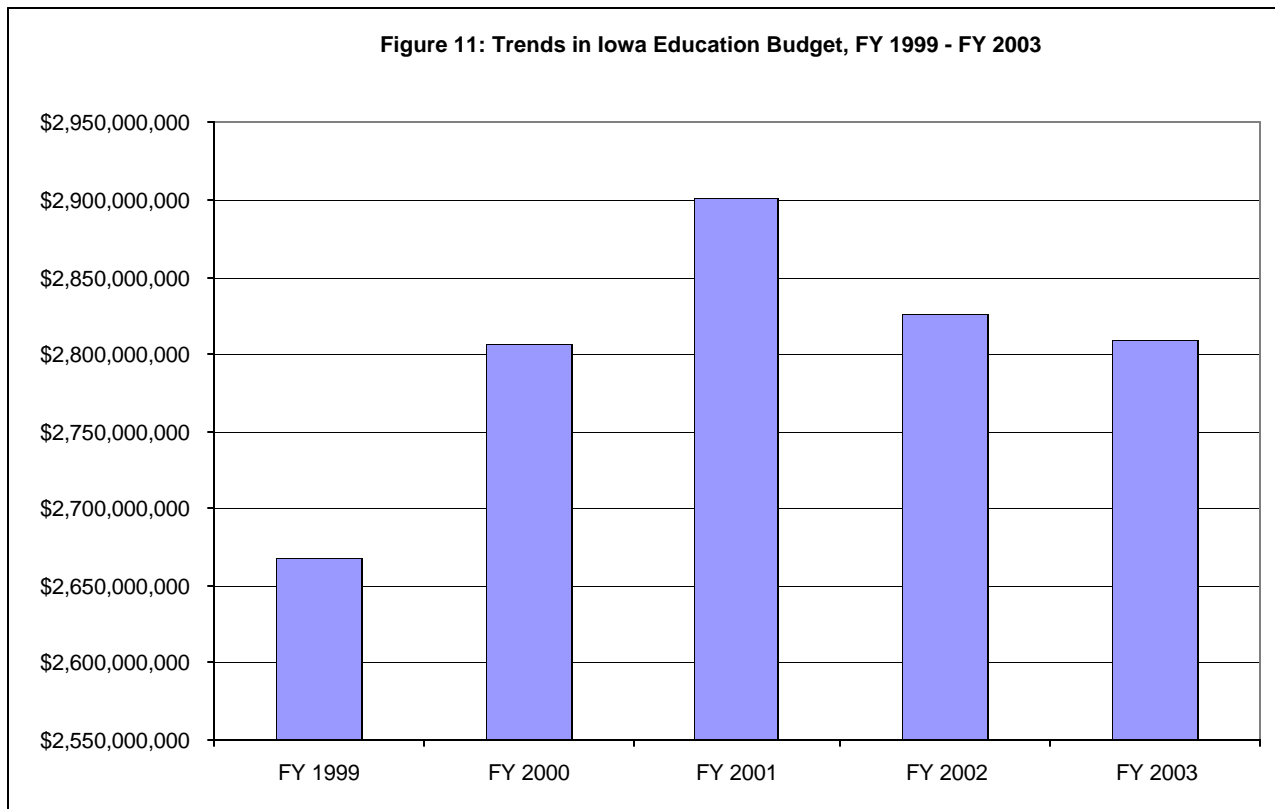
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Education is up 4.58% since FY 1999. Figure 11 shows the budget trend for Education for FY 1999 – FY 2003. Spending on Education is still up \$122 million over FY 1999 levels.

Some of the biggest increases in funding have occurred in Justice; Administration and Regulation; and Transportation, Infrastructure, and Capitals. The budget trends for these are displayed in Figures 12, 13, and 14, respectively. Justice funding is up 3.78% over FY 1999, a total of more than \$16 million over FY 1999 levels. Administration and Regulation is up 12.99% over FY 1999. More than \$17 million is being spent on Administration and Regulation in FY 2003 than was spent in FY

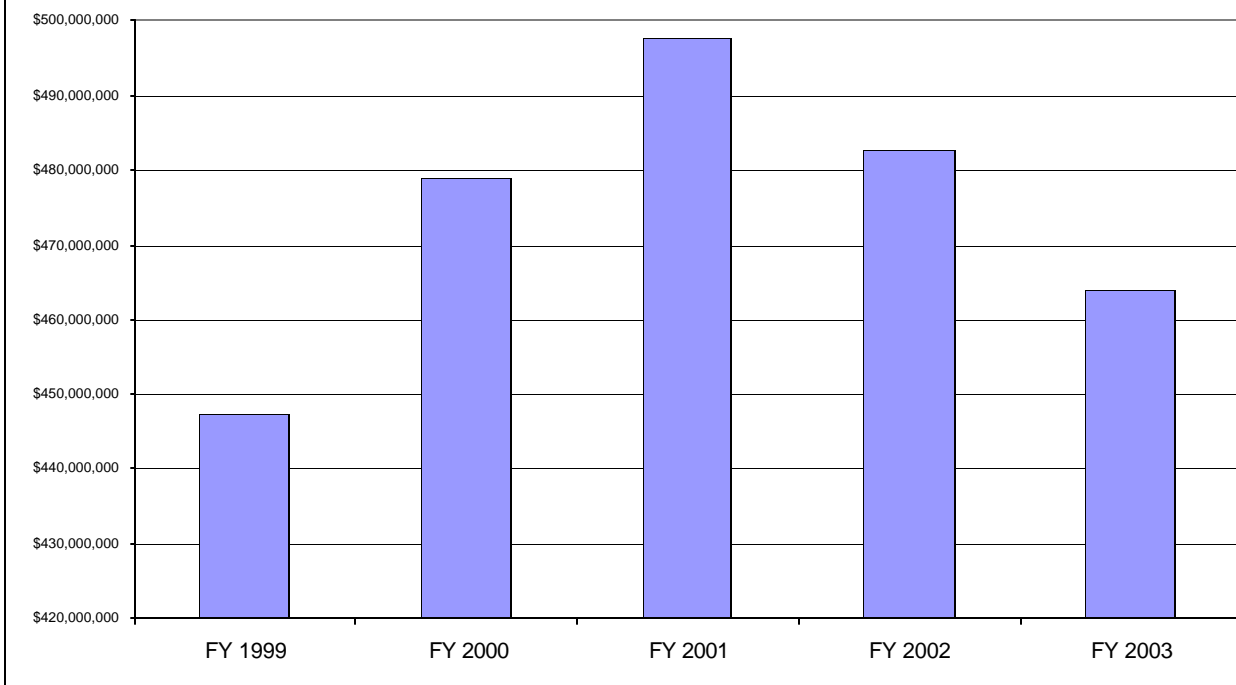
1999. The largest increase is in Transportation, Infrastructure, and Capitals, at 21.95%. This function is up more than \$84 million over FY 1999 levels.

Governor Vilsack and the State Legislature went on a spending binge in FY 2000 and FY 2001. As a result, the funding for the total budget and various budget functions is still above FY 1999 levels. Some of these functions are up over FY 1999 levels substantially. Thus, there is still plenty of room to make spending cuts if the budget crisis continues. That subject is addressed in the next section.



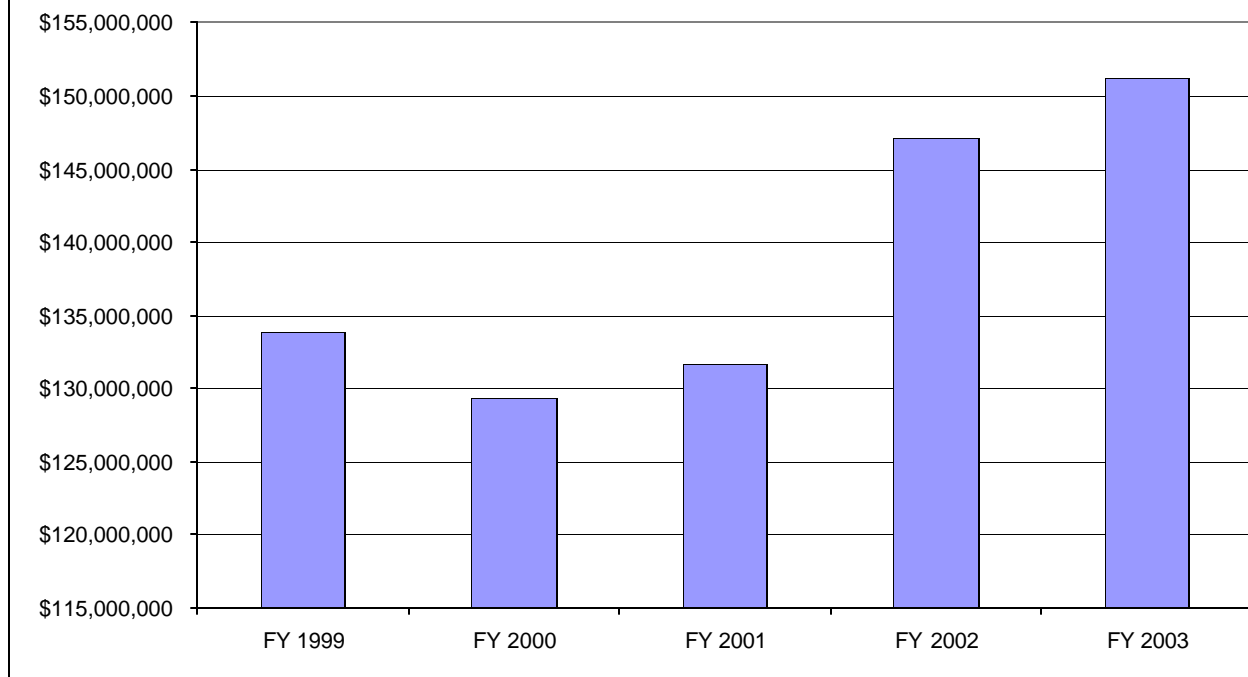
Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data

**Figure 12: Trend in Justice Budget, FY1999-FY2003**

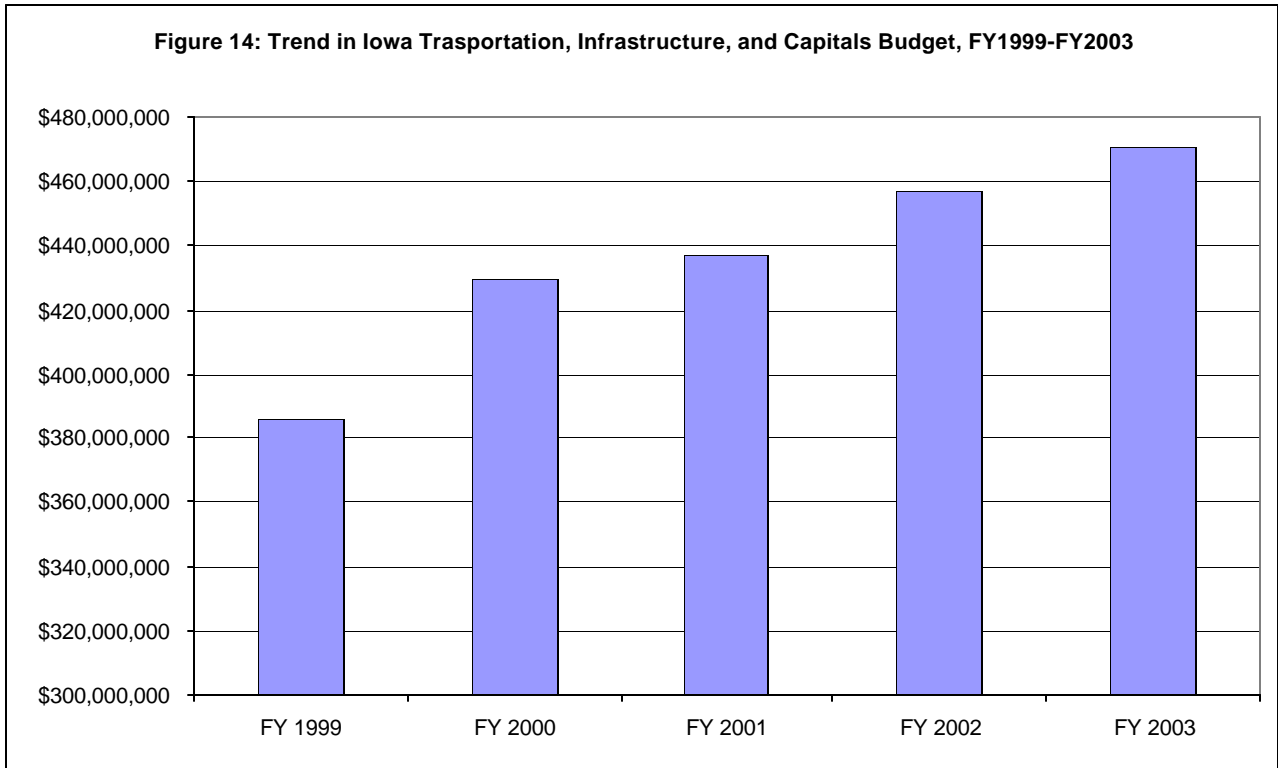


*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

**Figure 13: Trend in Iowa Administration and Regulation Budget, FY 1999 - FY 2003**



*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*



*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

**THE IMMEDIATE FUTURE**

As FY 2003 limps forward, it is quite possible that state revenue collections will not match the funding levels in the FY 2003 budget. This study proposes making more budget cuts. The best way is to make more cuts in the General Fund. To do this, we propose an across-the-board cut of 2.2% in the General Fund. This would save the state government just over \$100 million.

However, this is only a short-term solution. The long-term health of the Iowa budget will require some fundamental changes. These are addressed in the following section.

**LONG-TERM SOLUTIONS**

**A. State Employee Salaries**

We must look beyond Fiscal Years 2003 and 2004 to impose long-term stability on the Iowa budget. Only by doing this can we prevent another budget crisis from occurring in the future. One place to start is with state employee salaries.

Salaries for employees of the state of Iowa are some of the most generous in the nation. Prior research conducted by Public Interest Institute has found that, on average, state employees are paid 46% more than private sector employees in Iowa.<sup>28</sup> This is the result of state contracts that do nothing to restrain pay raises. For example, the contract negotiated with the Iowa Chapter of the American Federation of

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*“Another long-term solution to Iowa’s budget problems is the imposition of strict growth limits on the budget.”*

State, County, and Municipal Employees included a pay raise of 3% and 7% in FY 2001 and FY 2002, respectively.

In FY 2001, the 3% pay raise resulted in a \$92.7 million liability for the Iowa budget.<sup>29</sup> Had the raise been restricted to the inflation rate, the state would have saved more than \$24 million.<sup>30</sup> Future contracts must be negotiated to include fair and reasonable pay raises that do not put inordinate pressure on state finances.

## **B. Growth Limits on the Budget**

Another long-term solution to Iowa’s budget problems is the imposition of strict growth limits on the budget. For guidance in this, Iowa should look to the state of Colorado.

In 1992, Colorado voters approved a Constitutional Amendment to guard against runaway state government spending. The Taxpayers Bill of Rights (TABOR) restricts the growth in state revenue to inflation plus the percentage increase in state population in the calendar year prior to the start of the fiscal year. The state must also maintain an emergency reserve fund of at least 3% of its fiscal year spending. Any revenue collected in excess of this limit must be returned to the taxpayers in the form of rebates.

TABOR allowed state spending in Colorado to grow at the same level as inflation and population, but prevented the state from creating all sorts of

new programs and plans that would continue to require unsustainable amounts of funding when the good economic times came to an end. Without the TABOR limits, spending levels in the state of Colorado would likely have been much higher in the 1990s, resulting in bigger budget problems when state revenue began decreasing. “We didn’t overspend in the good years,” said Governor Bill Owens of Colorado.<sup>31</sup> That is why “Owens is one of the few governors this summer not sweating out their budgets.”<sup>32</sup>

Iowa should adopt spending limits similar to the ones in Colorado. Indeed, the Iowa Legislature has considered a TABOR in the past, most recently in 1995.<sup>33</sup> The one considered in 1995 included spending limits based on state population growth and inflation. The limits would have applied to both the General and the Non-General Fund.

This study projects what the Iowa budget situation would look like today had TABOR been adopted in 1995. The first budget TABOR would have applied to would have been the budget of FY 1997. Thus, the spending increase for FY 1997 is projected by using the amount of the budget of FY 1996 and adding increases based on population growth and inflation for calendar year 1996. The increase for FY 1998 is projected by using the projected amount of the budget for FY 1997 and adding increases based on population and inflation for calendar year 1997. This process

is repeated through FY 2003. (See Appendix 2 for calculations.) The results, compared with the actual budgets, are displayed in Figure 15.

Figure 15 shows that Iowa would still be running a budget surplus in FY 2002 and FY 2003 of more than \$272 million and \$142 million, respectively, had TABOR been enacted in 1995. From FY 1997-FY 2003 total budget savings would have been more than \$2.5 billion. In short, Iowa's budget would have been in the black for a long time to come had TABOR been enacted in 1995.

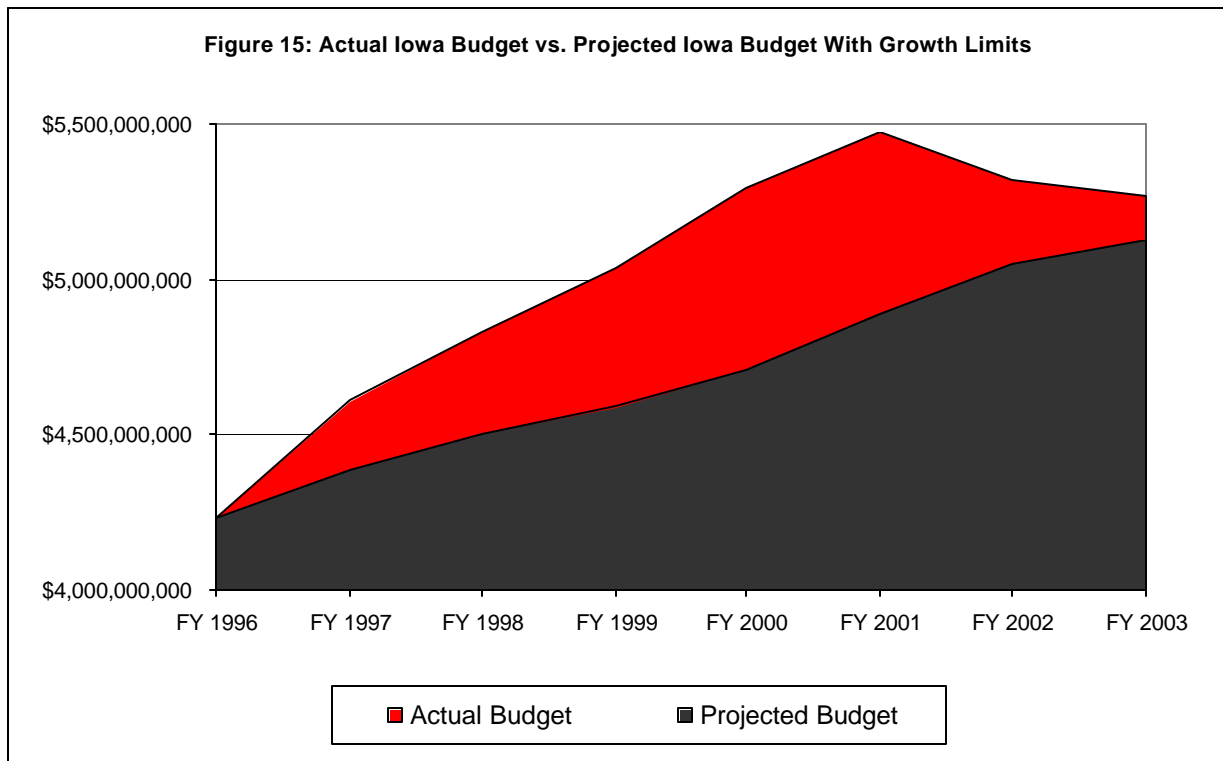
To prepare for the future, Iowa must adopt spending limits based on population growth and inflation. These limits must be applied to both the General and

the Non-General Funds. To apply them only to the General Fund will allow politicians to use the Non-General Fund to evade the limits, much as they are doing now with the 99% limit. Iowa Legislators should make enacting TABOR a top priority in the coming legislative session. It would be the first step in preventing future budget crises.

### CONCLUSION

Ultimately, what this analysis reveals is that proper fiscal management is not a priority for Governor Vilsack. Instead of working to restrain budget growth, Governor Vilsack, with the acquiescence of the State Legislature, used the budget process to massively increase

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Source: Public Interest Institute Analysis of Iowa Department of Revenue and Finance and Iowa Legislative Fiscal Bureau Data

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*“Raising taxes is not the solution to the crisis. The solution is to address state-government spending.”*

state spending. With the Iowa budget so bloated at the end of Vilsack's first two years in office, the stage was set for a serious budget crisis. That is exactly what happened when the economy fell into a relatively minor recession. The fiscal mismanagement of the early Vilsack years has left Iowa's budget in a big hole that may take years to climb out of.

The responsibility for the budget crisis does not lie with the Iowa taxpayers. The state government already imposes too heavy a burden on Iowa taxpayers. Thus, raising taxes is not the solution to the crisis.

The solution is to address state-government spending. For the time being, the Governor and State Legislature must make more budget cuts. This is the only responsible way to balance the budget in the immediate future. For the long term, the Governor and the State Legislature need to impose new spending limitations on the state budget. The current ones are inadequate. Iowa must adopt new ones that restrict spending to increases for inflation and population growth, and impose them on both the General Fund and Non-General Fund. This is the best method for preventing the spending binges like the one that caused the current crisis.

## ENDNOTES:

- <sup>1</sup> “Chapter 8.3,” Iowa Code 2001.
- <sup>2</sup> “Chapters 8.21 and 8.22,” Iowa Code 2001.
- <sup>3</sup> “Chapter 8.3,” Iowa Code 2001.
- <sup>4</sup> Iowa Constitution, Article 3, Section 16.
- <sup>5</sup> “Spending for Education Programs,” *Iowa Legislative News Service Bulletin*, Volume 34, Bulletin #19, February 11, 1999, p. 1.
- <sup>6</sup> Ibid.
- <sup>7</sup> “House & Senate Budget Targets Have \$192 Million Increase,” *Iowa Legislative News Service Bulletin*, Volume 34, Bulletin #23, February 22, 1999, p. 1.
- <sup>8</sup> “House & Senate Budget Targets Have \$192 Million Increase,” *Iowa Legislative News Service Bulletin*, Volume 34, Bulletin #23, February 22, 1999, p.1 and “Governor Insists on an Education Spending Agreement Before Tax Cuts,” *Iowa Legislative News Service Bulletin*, Volume 34, Bulletin #35, March 12, 1999, p. 1.
- <sup>9</sup> “House & Senate Budget Targets Have \$192 Million Increase,” *Iowa Legislative News Service Bulletin*, Volume 34, Bulletin #23, February 22, 1999, p. 1.
- <sup>10</sup> “Republicans Urge Governor to Sign Tax Cuts,” *Iowa Legislative News Service Bulletin*, Volume 34, Interim Report #3, May 21, 1999, p. 1.
- <sup>11</sup> “Vilsack Warns that Budget Growth Must Mirror Revenue Growth,” *Iowa Legislative News Service Bulletin*, Volume 34, Interim Report #10, September 10, 1999, p. 1.
- <sup>12</sup> “Republicans Propose Budget Cuts of \$40 Million,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #26, February 21, 2001, p. 1.
- <sup>13</sup> “Cuts to be Announced Tomorrow,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #25, February 20, 2001, p. 1.
- <sup>14</sup> “Senate Makes \$25 Million in Cuts,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #33, March 6, 2001, p. 1 and “Governor to Veto 1% Cut” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #36, March 12, 2001, p. 1.
- <sup>15</sup> “Governor Vilsack Unveils his Teacher pay Proposals,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #37, March 13, 2001, p. 1.
- <sup>16</sup> “New Estimates Are Out,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #38, March 14, 2001, p. 1.
- <sup>17</sup> Ibid.
- <sup>18</sup> “Governor Vilsack Releases the Revised Budget,” *Iowa Legislative News Service Bulletin*, Volume 36, Bulletin #46, March 28, 2001, p. 1.

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<sup>19</sup> "The Condition of the State," *Iowa Legislative News Service Bulletin*, Volume 37, Bulletin #2, January 15, 2002, p. 1.

<sup>20</sup> "Details from the Governor," *Iowa Legislative News Service Bulletin*, Volume 37, Bulletin #31, March 8, 2002, p. 1.

<sup>21</sup> "Deficit Hits \$200 Million; Governor Vetoes Parts, Approves Parts of Budget," *Iowa Legislative News Service Bulletin*, Volume 37, Interim Report #5, May 13, 2002, p. 1.

<sup>22</sup> "Special Session Concludes in One Day," *Iowa Legislative News Service Bulletin*, Volume 37, Interim Report #6, May 29, 2002, p. 1.

<sup>23</sup> "Editorial: It's Not Just a Temporary Problem," *Des Moines Register*, May 12, 2002, <<http://www.desmoinesregister.com/news/stories/c5917686/18139227.html>> (August 28, 2002.)

<sup>24</sup> According to the Legislative Fiscal Bureau, in January 2001 the two parts of the Rainy Day Fund, the Economic Emergency Fund and the Cash Reserve Fund, each had \$242.9 million in them, for a total of \$485.8 million. As of September 4, 2002, the Economic Emergency Fund had only \$21.5 million left, and the Cash Reserve Fund had only \$143.7 million. That is a decline of \$320.6 million, or 65.99%.

<sup>25</sup> "Chapter 8.54," Iowa Code 2001.

<sup>26</sup> "State Budget and Tax Actions 2002: Preliminary Report," National Conference of State Legislatures, July 24, 2002, <<http://www.ncsl.org/programs/fiscal/presbta02.htm>> (August 13, 2002.)

<sup>27</sup> "Study: Iowa cut deeper than any other state," *Waterloo/Cedar Falls Courier*, Thursday, July 25, 2002, p. A3, column 1.

<sup>28</sup> Steven B. Garrison, "Iowa's Privileged Class I—State Government Employees," Institute Brief, Vol. 9, No. 13, Public Interest Institute.

<sup>29</sup> "Governor and Union Work on Early Retirement Plan for State Employees," *Iowa Legislative News Service Bulletin*, Volume 26, Interim Report 15, October 19, 2001, p. 1.

<sup>30</sup> The savings is calculated as follows. Since a 3% increase equaled \$92.7 million, total salary was calculated as  $\$92,700,000 / .03 = \$3,090,000,000$ . Inflation for that period was 2.21%. Thus, a pay raise based on inflation is  $\$3,090,000,000 * .0221 = \$68,289,000$ . Savings calculated as  $\$92,700,000 - \$68,300,000 = \$24,400,000$ .

<sup>31</sup> John J. Miller, "America's Best Governor," *National Review*, September 2, 2002, p. 17.

<sup>32</sup> Ibid.

<sup>33</sup> A copy of the "Taxpayers' Rights Amendment to Iowa Constitution" can be found at <[http://www.taxrelief.org/tax\\_info/index.htm](http://www.taxrelief.org/tax_info/index.htm)>.

## Appendix 1: Data Sources

**Iowa Budget Data:** All data on the Iowa budget provided by the Iowa Legislative Fiscal Bureau.

**Iowa Tax Data:** Data on Iowa taxes provided from both the Iowa Department of Revenue and Finance and the Iowa Legislative Fiscal Bureau. Tax data from the Iowa Legislative Fiscal Bureau available online at <<http://staffweb.legis.state.ia.us/lfb/mrmemo/mrmemo.html>>.

**Iowa and United States Personal Income:** All personal income data is available from the Bureau of Economic Analysis at <<http://www.bea.doc.gov/bea/regional/data.htm>>.

**Iowa Population:** All data on population is available from the Bureau of Economic Analysis at <<http://www.bea.doc.gov/bea/regional/spi/>>.

**Inflation:** All data on inflation is available from the Bureau of Labor Statistics using the BLS Inflation Calculator at <<http://stats.bls.gov/>>.

## Appendix 2: Projected Budget Based on Inflation and Population Growth Limits

Fiscal Year	Inflation	Population Growth	Projected Budget Increase	Projected Budget	Actual Budget	Difference (Actual - Projected)
1996					\$4,233,529,182	
1997	2.95%	0.583%	\$149,570,586	\$4,383,099,768	\$4,609,292,677	\$226,192,909
1998	2.29%	0.438%	\$119,570,962	\$4,502,670,730	\$4,831,347,322	\$328,676,592
1999	1.56%	0.386%	\$ 87,621,972	\$4,590,292,702	\$5,037,291,936	\$446,999,234
2000	2.21%	0.407%	\$120,127,960	\$4,710,420,662	\$5,292,818,906	\$582,398,244
2001	3.36%	0.506%	\$182,104,863	\$4,892,525,525	\$5,471,580,523	\$579,054,998
2002	2.85%	0.337%	\$155,924,788	\$5,048,450,313	\$5,320,590,183	\$272,139,870
2003	1.69%	-0.148%	\$ 77,847,104	\$5,126,297,417	\$5,286,322,612	\$142,025,195
<b>Total:</b>					\$2,577,487,042	

Notes: Population growth is the rate of growth in the state of Iowa. The calculation for the projected budget increase for FY 1997 is [Actual Budget FY 1996 \* Inflation] + [Actual Budget FY 1996 \* Population Growth]. All subsequent projected budget increases are based on the projected budget of the previous fiscal year. For example, the calculation for the projected budget increase for FY 1998 is [Projected Budget FY 1997 \* Inflation] + [Projected Budget FY 1997 \* Population Growth].

The inflation and population growth rates used for each calculation are the rates for the calendar year *previous* to the start of each fiscal year. For example, FY 1997 began July 1, 1996. Thus, the inflation and population growth rates from calendar year 1995 are the ones used to calculate the projected increase for FY 1997.

## Appendix 3: Selected Budget Amounts, Fiscal Year 1999 to Fiscal Year 2003

### Fiscal Year 1999

	General Fund	Non-General Fund	Combined
Administration and Regulation	\$ 106,755,939	\$ 27,060,803	\$ 133,816,742
Education	\$2,661,633,697	\$ 6,201,983	\$ 2,667,835,680
Human Services	\$ 838,769,657	\$ 10,169,721	\$ 848,939,378
Justice System	\$ 430,184,416	\$ 16,957,133	\$ 447,141,549
Transportation, Infrastructure, and Capitals	\$ 3,968,997	\$ 381,695,023	\$ 385,664,020
<b>Total Budget</b>	<b>\$4,529,868,343</b>	<b>\$ 507,423,593</b>	<b>\$ 5,037,291,936</b>

### Fiscal Year 2000

	General Fund	Non-General Fund	Combined
Administration and Regulation	\$ 106,040,494	\$ 23,256,107	\$ 129,296,601
Education	\$2,806,115,111	\$ 500,000	\$ 2,806,615,111
Human Services	\$ 883,695,895	\$ 8,474,531	\$ 892,170,426
Justice System	\$ 472,041,506	\$ 6,948,338	\$ 478,989,844
Transportation, Infrastructure, and Capitals	\$ 3,924,672	\$ 425,768,679	\$ 429,693,351
<b>Total Budget</b>	<b>\$4,763,573,422</b>	<b>\$ 529,245,484</b>	<b>\$ 5,292,818,906</b>

### Fiscal Year 2001

	General Fund	Non-General Fund	Combined
Administration and Regulation	\$ 104,572,299	\$ 27,068,270	\$ 131,640,569
Education	\$2,900,466,555	\$ -	\$ 2,900,466,555
Human Services	\$ 783,015,930	\$ 33,135,000	\$ 816,150,930
Justice System	\$ 496,009,038	\$ 1,660,000	\$ 497,669,038
Transportation, Infrastructure, and Capitals	\$ 3,039,443	\$ 433,946,756	\$ 436,986,199
<b>Total Budget</b>	<b>\$4,886,870,809</b>	<b>\$ 584,709,714</b>	<b>\$ 5,471,580,523</b>

### Fiscal Year 2002

	General Fund	Non-General Fund	Combined
Administration and Regulation	\$ 92,374,401	\$ 54,752,291	\$ 147,126,692
Education	\$2,784,831,730	\$ 41,153,250	\$ 2,825,984,980
Human Services	\$ 850,373,386	\$ 24,621,426	\$ 874,994,812
Justice System	\$ 476,963,764	\$ 5,660,000	\$ 482,623,764
Transportation, Infrastructure, and Capitals	\$ 2,699,019	\$ 454,471,270	\$ 457,170,289
<b>Total Budget</b>	<b>\$4,610,277,778</b>	<b>\$ 710,312,405</b>	<b>\$ 5,320,590,183</b>

**Fiscal Year 2003**

	<b>General Fund</b>	<b>Non-General Fund</b>	<b>Combined</b>
<b>Administration and Regulation</b>	\$ 76,684,927	\$ 74,512,443	\$ 151,197,370
<b>Education</b>	\$2,720,054,783	\$ 70,053,250	\$ 2,790,108,033
<b>Human Services</b>	\$ 732,569,127	\$ 31,621,426	\$ 764,190,553
<b>Justice System</b>	\$ 457,322,121	\$ 6,710,000	\$ 464,032,121
<b>Transportation, Infrastructure, and Capitals</b>	\$ 600,000	\$ 470,325,107	\$ 470,925,107
<b>Total Budget</b>	\$4,468,815,841	\$ 742,771,675	\$ 5,268,322,612

Notes: Only selected budget functions are presented here. Thus, the numbers for the budget functions do not equal the numbers for the Total Budget. All numbers presented here exclude federal funding. Numbers for Education and Human Services include any state funds under Unassigned Standing earmarked for those purposes.

## Appendix 4: Dynamic Scoring of Iowa Tax Revenues

### Regression Results:

Sample Range: 1991.3 – 2002.1  
 Number of Observations: 43  
 Prais-Winstein AR(1) Regression—Iterated Estimates

### Dependent Variable: LLaInc

Variable	Coefficient	Std. Error	T-Stat	Sig.
<b>C</b>	-5.0916	.3977	-12.80	0.000
<b>LUSInc</b>	.3915	.0522	7.51	0.000
<b>LUSInc(-1)</b>	.3355	.0497	6.76	0.000
<b>LIIncTR</b>	-.9480	.0429	-22.07	0.000

R-Squared: 0.999  
 Adjusted R-Squared: 0.999  
 Durbin-Watson statistic (original): 0.140  
 Durbin-Watson statistic (transformed): 0.959

### Explanation of Variables:

LLaInc: Log of seasonally adjusted Iowa personal income  
 LUSInc: Log of seasonally adjusted U.S. personal income  
 LUSInc(-1): Log of seasonally adjusted U.S. personal income lagged one period  
 LIIncTR: Log of Iowa personal income tax ratio; Iowa personal-income tax ratio is seasonally adjusted total Iowa taxes divided by seasonally adjusted Iowa personal income

### Explanation of Calculations:

The Iowa personal-income tax ratio for Fiscal Year 2001 *IIncTR (FY 2001)* is the personal-income tax collections for FY 2001 divided by Iowa personal income for FY 2001. The Iowa personal-income *IaInc(FY 2001)* is \$79,192,000,000.

$$IIncTR(FY 2001) = .02581$$

$$IaInc(FY 2001) = \$79,192,000,000$$

The Iowa personal-income tax ratio for 1997, before the 10% personal-income tax cut, was 2.643%. In 1998, the year after the 10% personal-income tax cut had taken effect, the Iowa personal-income tax ratio was 2.613%. The percent change in the ratios is  $(2.613 - 2.643) / 2.643 = 1.14\%$

$$\text{Personal-income tax revenue for FY 2001} = 2.581\% * 79,192,000,000 = \$2,043,945,520.$$

$$\text{An increase of 10\% in personal income taxes in FY 2001 changes the personal-income tax ratio as follows: } 0.0114 * 2.581 = 0.029$$

$$\text{New Personal income tax ratio for FY 2001: } 2.581 + 0.029 = 2.61.$$

Given a tax elasticity of -0.948, a change of 1.14% in IncTR (personal income tax rate) will change the IaInc (personal income) by -1.081%.

$$\$79,192,000,000 * (-1.081\%) = \$856,065,520 \text{ (loss in personal income)}$$

$$\$79,192,000,000 - \$856,065,520 = \$78,335,934,480 \text{ (new personal income)}$$

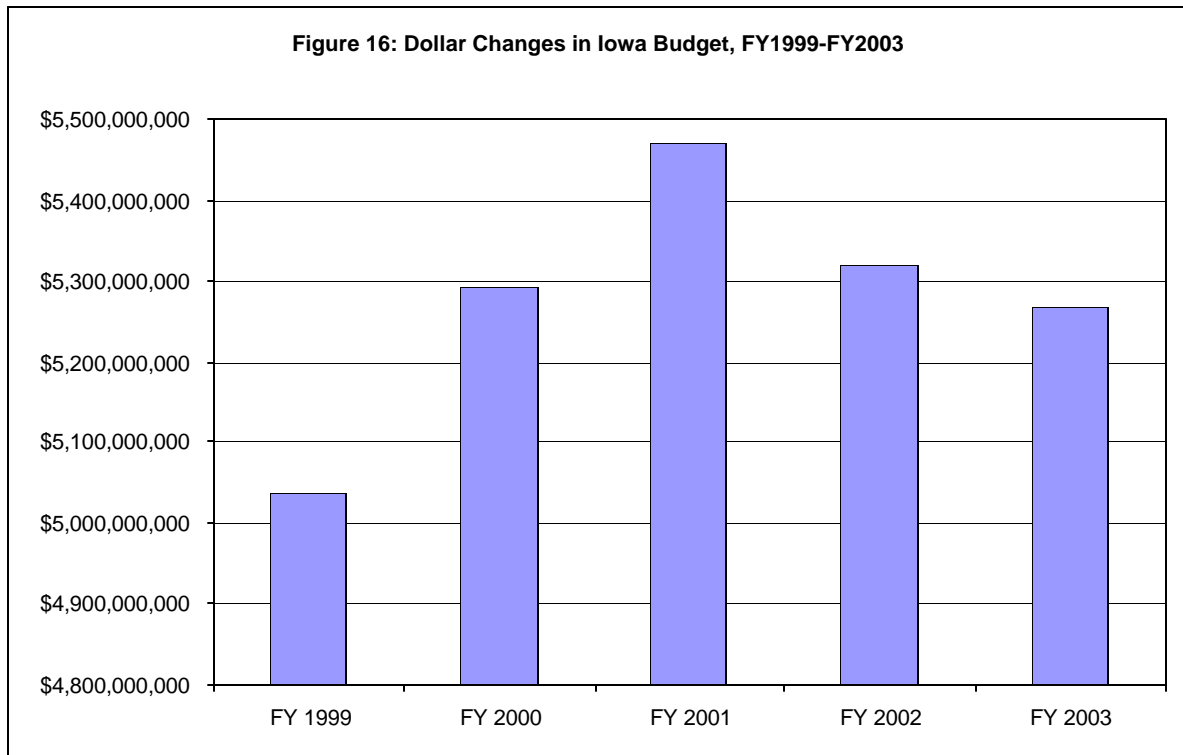
$$\text{New personal-income tax revenue:}$$

$$2.616\% * \$78,339,102,169 = \$2,044,567,889$$

$$\text{Personal-income tax loss in FY 2001:}$$

$$\$2,044,567,890 - \$2,043,945,520 = \$622,370$$

## Appendix 5: Miscellaneous Figures



*Source: Public Interest Institute Analysis of Iowa Legislative Fiscal Bureau Data*

### **Acknowledgements:**

The authors thank these people: Professor David Tuerk, Beacon Hill Institute, and Professor Geoff Peterson, University of Wisconsin Eau-Claire, provided immense help with the statistical analysis. The employees of the Iowa Legislative Fiscal Bureau and the Iowa Department of Revenue and Finance provided invaluable amounts of data on the Iowa budget and Iowa tax revenues. Finally, thanks to Jeff Boeyink of Iowans for Tax Relief for providing information on the Taxpayers' Bill of Rights.

# ***POLITICS, TAXATION, AND THE RULE OF LAW***

Edited by Dr. Donald P. Racheter, President of Public Interest Institute, and  
Dr. Richard E. Wagner, Economics Professor at George Mason University and  
Chairman of the Institute's Academic Advisory Board.

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## ***Breaking Microsoft by Shattering Windows: The Costly Assault on Consumers by Iowa’s Attorney General***

Iowa is one of nine states whose Attorneys General have refused to settle outstanding antitrust actions against Microsoft, and have chosen instead to proceed with additional litigation. This litigation proposes 16 different remedies for the Court to impose beyond those already granted. These proposals would have two main effects. One effect would be to impose a large excise tax on the consumers of Windows, which in turn would degrade severely the quality of what would then be a higher-cost product. The second would be to transform Microsoft from a vigorous and independent company into a form of public utility. This kind of transformation of Microsoft into a public utility cannot be good for consumers. The primary beneficiaries of this transformation would be such gigantic competitors to Microsoft as AOL Time Warner, Sun Microsystems, Oracle, Apple, and IBM. Consumers, however, would lose, and would lose mightily.

## ***Iowa’s \$300,000,000 Tax Increase***

During the legislative session of 2001, bill HF 660, which called for increasing the state sales tax from five cents to six cents per dollar spent, came before the Iowa Legislature. According to the current fiscal year sales tax estimates of the Revenue Estimating Conference, which the state must use to plan its budget, this tax increase would amount to just under \$300,000,000 in new taxes levied upon the people of Iowa. The stated purpose of this proposed tax increase was to fund school infrastructure, that is, the physical buildings and upkeep of those buildings. This bill has been reintroduced this year as SF 2005 by Senator John Jensen. Since this tax increase would affect all Iowa consumers if passed, it is reasonable to examine its effects on the citizens of Iowa and the validity of the arguments concerning this bill.

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