



## Impact of the Insurance Premium Tax Rate Reduction

### **ISSUE**

In 2002 (SF 2318 – Insurance Premium Tax Reduction Act), the Iowa General Assembly approved a reduction in the Insurance Premium Tax rate from 2.0% to 1.0%. The reduction was phased in at the rate of one-quarter percent annual increments over a five-year period, beginning with life and health insurance policy payments made on or after January 1, 2003. Calendar year 2007 was the first year all premiums were taxed at 1.0% and FY 2008 was the first full fiscal year at the 1.0% rate.

Insurance premium tax is paid only by insurance companies. The companies that benefit from the tax reduction are uniquely identified in government employment statistics. This allows for a unique opportunity to evaluate both the revenue impact and the employment impact of the tax rate reduction in SF 2318. This **Issue Review** focuses on the General Fund revenue impact of the rate reduction and the Iowa employment trends for the insurance industry since the rate reduction legislation was approved.

### **CODE AUTHORITY**

Chapter 432

### **BACKGROUND**

Insurance carrier employment is a significant contributor to Iowa total employment. Iowa's total insurance carrier employment equaled 30,071 for calendar year 2007, a level that ranked Iowa 15<sup>th</sup> in total U.S. insurance carrier employment. In contrast, total private sector employment for Iowa ranks 24<sup>th</sup> among the 53 states and territories.<sup>1</sup> Iowa insurance carrier employment equals 2.4% of total private employment in Iowa, while U.S. insurance carrier employment equals 1.1% of total U.S. private employment.

Iowa reduced the insurance premium tax rate from 2.0% to 1.0% in part to make Iowa domiciled insurance companies more competitive in states with a tax rate lower than 2.0%.

The method states use to tax insurance companies is unique in state business taxation. For most states, insurance companies do not pay corporate income tax on profits derived from insurance sales. Instead, insurance companies pay a tax equal to a set percent of premiums collected on policies issued within a state. That rate currently ranges from 0.500% to 4.265% nationally. In addition, states have retaliatory tax provisions that require companies not domiciled within that state to pay a tax rate equal to what a domestic (in-state) company would pay in their home state, if the taxes owed would be higher. This domicile provision creates a situation where lowering the tax rate in a state will lower the taxes paid by that state's companies to other states.

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<sup>1</sup>The employment numbers and rankings include the 50 states, Puerto Rico, the Virgin Islands, and Washington, DC.

Reducing the insurance premium tax rate in Iowa from 2.0% to 1.0% allows companies to either profit 1.0% more from insurance sales or allows consumers to purchase insurance at a 1.0% lower rate. The Iowa rate reduction also reduces taxes paid to certain other states by Iowa companies selling insurance in those states due to reduced or eliminated retaliatory tax calculations. If Iowa-based companies are 1.0% more profitable on Iowa sales and if Iowa-based companies are more competitive and profitable in other states, they may expend some of the additional profits employing more Iowans.

### **ESTIMATED REVENUE IMPACT**

#### **Estimating Insurance Premium Tax Reduction**

For the year prior to the start of the Insurance Premium Tax phase-down (FY 2003), Iowa received \$145.8 million in Insurance Premium Tax revenue. For FY 2008, Iowa received \$111.7 million. To estimate the amount of tax revenue the State would have received had the rate remained at 2.0%, Iowa's receipt history for that time period was compared to the history of all states and territories. **Table 1** provides the actual receipts, estimated receipts had the rate not been reduced,<sup>2</sup> and a difference column. The estimate concludes that the direct impact on General Fund tax receipts was a reduction of \$65.7 million in FY 2008 and \$245.4 million over the five fiscal years since the rate phase-down was initiated.

	Actual Iowa Insurance Premium Receipts	Estimated Iowa Receipts Without Rate Reduction	Estimated Direct Fiscal Impact
FY 2003	\$ 145,836	\$ 145,836	\$ 0
FY 2004	144,629	161,132	-16,503
FY 2005	131,183	171,027	-39,844
FY 2006	121,428	173,478	-52,050
FY 2007	105,223	176,498	-71,275
FY 2008	111,653	177,399	-65,746
Total			\$ -245,417

<sup>2</sup>Actual Iowa and national insurance tax revenues were provided by the U.S. Census Bureau. Insurance revenue amounts by state and by year are found at <http://www.census.gov/govs/www/statetax.html> and were accessed in October of 2008. Actual Iowa receipts for 2003 and 2004 were adjusted for:

1. A positive \$10.0 million withdrawal from insurance premium receipts authorized by the General Assembly.
2. A negative \$6.4 million to account for a change in the tax due dates. That amount was added to the 2004 amount, for a net adjustment of zero across the two years.

For the five-year period preceding the start of the tax decrease (1998 through 2002), Iowa insurance premium tax revenue grew 34.0%, or 93.4% of the U.S. rate of 36.3% over the same time period.

To estimate the level of Iowa Insurance Premium Tax receipts without the rate reduction, tax receipts for 2003 through 2008 were assumed to have grown at a rate equal to 93.4% of the U.S. growth rate each year.

### **Additional Significant Insurance Industry Incentive**

The tax rate reduction is not the only insurance industry expansion incentive available. Insurance companies are eligible for several significant economic development tax incentive programs. The Department of Economic Development (DED) reports that several insurance carriers have received financial incentives to increase employment in Iowa since enactment of SF 2318. The largest of those was to support construction of the Allied/Nationwide Insurance buildings in downtown Des Moines.<sup>3</sup> That project received a State and local incentive package totaling approximately \$109.0 million over 20 years.<sup>4</sup>

### **Estimating the Change in Employment**

Reducing the Insurance Premium Tax rate has three impacts on Iowa employment that may be estimated.

1. Direct impacts on employment by insurance companies in Iowa due to reduced taxes owed to Iowa and retaliatory taxes to other states.
  - a. The impact of the rate reduction on all companies selling within the State. All Iowa-domiciled companies as well as companies domiciled in other states with a tax rate lower than 2.0% benefited from a reduction in the amount of tax owed to the State of Iowa. If a company benefiting from this reduction in the Iowa tax rate has a significant employee base in Iowa, the company may choose to employ more Iowans.
  - b. Iowa-domiciled companies doing business in other states with a tax rate less than 2.0% saw a reduction in the Insurance Premium Tax owed in several other states. If a company benefiting from this reduction in retaliatory taxes has a significant employee base in Iowa, they may choose to employ more Iowans.<sup>5</sup>

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<sup>3</sup>Several smaller projects were not included in the job creation incentive expense calculation. Also, two recently approved large projects, Wellmark in downtown Des Moines and AVIVA in West Des Moines, are not included in the incentive calculation since the buildings are not yet complete so it is assumed employment has not been impacted.

<sup>4</sup>The LSA collected information from the Iowa Department of Economic Development, Polk County, and the City of Des Moines concerning the incentive package associated with the Allied/Nationwide project. Identified incentives include:

1. Job training tax credits (employee income tax withholding) - \$17.9 million
2. Investment tax credits - \$13.3 million
3. Reimbursement of Sales/Use tax paid during construction - \$3.3 million
4. Physical Infrastructure Assistance Program Forgivable Loan - \$7.7 million
5. Polk County grant - \$10.0 million
6. City of Des Moines financial assistance totaling \$56.8 million over 20 years
7. Partial property tax abatement during construction on two buildings and for ten years on two parking ramps.

Once constructed, the Allied/Nationwide properties should create approximately \$160.0 million in new taxable value. At FY 2009 property tax rates, this amount would generate \$7.3 million in annual property tax revenue once all abatements are exhausted. Of that annual amount, approximately \$928,000 will go towards local government debt levies, \$2.0 to \$3.0 million will be used by the City of Des Moines to pay incentives to Nationwide, and the remainder will be available to the City of Des Moines as Tax Increment Financing revenue, should the city choose to capture it.

<sup>5</sup>A company is not required to have a significant portion of its workforce in Iowa to be an Iowa-domiciled company. The website of the Insurance Division lists 94 Iowa-domiciled insurance carriers. The Division website lists out-of-state address for 20 of the 94.

- c. Companies domiciled in states with an Insurance Premium Tax rate in excess of 1.0% may choose to become an Iowa-domiciled company and may choose to move employment to Iowa. Becoming an Iowa-domiciled company will lower the company's tax payments in several other states.<sup>6</sup>
2. Indirect and induced employment impact due to the expansion of insurance industry employment in Iowa. Companies providing services to the insurance industry will expand employment if the industry expands (indirect employment gains), and the additional insurance industry employees will expend a portion of their salaries in Iowa and this will further expand employment (induced employment gains). This impact is often referred to as a "multiplier effect."
3. Impact on State government finances - Reducing Insurance Premium Tax rates reduces the amount of revenue raised by Iowa. Unlike the federal government, Iowa government cannot run a deficit so a reduction in one revenue source must be compensated through either an increase in another revenue source, a reduction in expenditures, or a combination of the two. Increasing another tax or decreasing government expenditures both have negative impacts that offset the positive impacts of the Insurance Premium Tax reduction to some degree.

The first step is to estimate the direct employment gains (item 1 above). Iowa insurance industry employment increased 2,144 jobs from the year prior to enactment of SF 2318 through 2007. However, insurance industry employment for the United States actually contracted during that time period. This analysis assumes the U.S. rate of insurance industry employment growth is the base growth rate, with Iowa employment growth calculated from that base. For 2001, Iowa insurance industry employment equaled 2.13% of U.S. employment for the industry. By 2007, that ratio expanded to 2.38%. **Table 2** calculates the difference between actual Iowa employment and the level of Iowa employment expected had Iowa remained at the 2001 level of 2.13% of U.S. insurance carrier employment.

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<sup>6</sup>The Iowa Insurance Division reports that since 2002, twelve insurance companies have changed their domicile to Iowa and four Iowa companies have changed their domicile from Iowa to another state. Of the twelve moving to Iowa, four are from states with a lower tax rate than Iowa and the remaining eight are from states with rates ranging from 1.4% to 2.0%. For four of those eight, the Insurance Division's official mailing address for the company remains outside of Iowa.

All four companies that changed their domicile status from Iowa to another state changed to a state with a higher rate than Iowa's current 1.0%.

Calendar Year	U.S. Total Insurance Carrier Employment	Iowa Insurance Carrier Employment	Iowa % of U.S. Total	Potential Iowa Insurance Carrier Employment Increase *
2001	1,312,143	27,927	2.13%	0
2002	1,299,475	27,716	2.13%	59
2003	1,307,566	27,725	2.12%	-105
2004	1,279,985	27,747	2.17%	504
2005	1,270,738	28,126	2.21%	1,080
2006	1,270,478	29,155	2.29%	2,115
2007	1,264,840	30,071	2.38%	3,151

\*Assumes Iowa had remained at 2.13% of U.S. total if the tax reduction and other incentives were not offered.

The second step is to estimate the multiplier effect for indirect and induced job creation, that is, the number of additional jobs created for each direct job created. For this analysis, a multiplier effect for job creation of 2.23 is used.<sup>7</sup> This means for every 100 direct jobs created, 123 indirect jobs are also created due to the increased economic activity generated by the direct jobs. With a multiplier of 2.23, the direct job increase of 3,151 would produce an additional 3,876 indirect jobs.

The third step is to estimate the number of job reductions associated with the State fiscal response to the tax revenue reduction associated with the Insurance Premium Tax rate phase-down. For the purpose of estimating the Iowa fiscal response, the Regional Economics Model, Inc. (REMI) model was used. A model simulation was used to reduce Iowa government expenditures by the amounts shown in the right hand column of **Table 1**, with a \$65.746 million decrease assumed for year six and future years. The model results indicate an employment reduction of 1,211 by the sixth year, with similar reductions for each year going forward. The REMI model results include both direct and indirect impacts.

<sup>7</sup>The LSA research produced four job creation or income multipliers used publicly for calculating employment feedback for Iowa insurance industry job creation. The Department of Economic Development economic model created in 2003 used 1.77, the Regional Economics Modeling, Inc. (REMI) model purchased by several State agencies uses about 1.60, Des Moines City Council minutes of February 1, 2000, reference 2.23 from a study the City commissioned from David Swenson, an economist at Iowa State University, and the model used by Ernst & Young, LLP to create impact projections for 2002 legislative discussions of SF 2318 used a multiplier of 2.60.

	Number of Jobs
Direct Employment Gains	3,151
Indirect Employment Gains	3,876
Deduction Due to Reduced Government Expenditures	(1,211)
Net Job Creation	<u>5,816</u>

### **FISCAL IMPACT**

This analysis indicates Iowa's Insurance Premium Tax change reduced industry tax payments to Iowa by \$245.4 million through FY 2008, with annual direct revenue reductions going forward of at least \$65.7 million. In addition, State and local incentives to one insurance company expansion totaled an estimated \$109.0 million over 20 years. Two more significant expansions have also received benefits and are in the planning and construction phases. Those two projects may further increase Iowa's share of insurance industry employment, but they will also significantly increase the amount of taxpayer incentives provided to the industry.

Since enactment of the rate reduction in 2002, Iowa insurance carrier employment has expanded faster than insurance carrier employment in the U.S., indicating the tax reduction and other incentives may have had a positive impact on Iowa employment. This analysis estimates that by the end of 2007, Iowa employment may have increased by 3,151 insurance carrier jobs and by 5,816 jobs overall due to the Insurance Tax rate reduction as well as State and local company-specific tax incentives.

Increased employment produces a revenue "feedback" as the employer expansions and new jobs produce increased economic activity. This feedback will replace a portion of the State and local revenue reduction associated with the insurance industry tax incentives.

As a reference, the LSA calculates that in Iowa, State and local governments currently collect approximately \$7,700 in taxes per job per year, so 5,816 average jobs would produce a total of \$44.8 million in State and local taxes each year.

Compared to other states, Iowa has a low unemployment rate and a high labor force participation rate. This means that compared to other states, it is more difficult in Iowa to expand employment without drawing in workers from outside the borders. To the extent the increased employment expands Iowa's population, State and local governments will see increased demand for services. Some portion of the revenue feedback discussed in the previous two paragraphs will be needed to pay for government service expansion.

As an example expense, there is one child in the public K-12 school system in Iowa for every 3.17 jobs, and each child takes \$9,970 on average in State and local tax revenue to educate

each year.<sup>8</sup> Using these averages, the children of 5,816 employed Iowans cost \$18.3 million to educate each year.

**CONCLUSION**

The structure of State insurance industry taxation provides a unique opportunity to evaluate the results of stimulative efforts to maintain and increase industry investment and employment in the State of Iowa. This analysis shows that while the efforts to expand the industry may have produced positive results in terms of capital investment and job creation; the taxpayer investment to produce those results has been significant in recent years.

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<sup>8</sup>For the education expense calculation, the most recent annual average of Iowa non-farm jobs was used (1,523,100) and the FY 2009 budget enrollment of 480,609 students (K-12). Taxes for education include all State General Fund appropriations to directly support K-12 public education, property taxes collected by schools, General Fund school infrastructure support (former local option), and local option income surtax revenue for schools.