Iowa Legislative Fiscal Bureau

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Effect Of OBRA On State Revenues

ISSUE

The federal Omnibus Budget Reconciliation Act of 1993 (OBRA) contained a number of revenue provisions designed to raise federal receipts. Many of these provisions will have direct or indirect effects on the State's revenues.

AFFECTED AGENCIES

Department of Revenue and Finance (DRF)

BACKGROUND

The OBRA compromise was reached in August 1993. The OBRA addressed both appropriations and receipts and is expected to raise approximately $240.0 billion in new revenues over 5 years. The appropriation changes will be addressed in another Issue Review.

When the federal government changes its tax policies, Iowa is generally affected in 2 ways. Initially, the amount of taxable income reported on Iowa individual and corporate income tax returns is likely to change by the amount that is deducted due to federal deductibility. (Currently, 100.0% of federal income tax is deductible on individual returns, and 50.0% is deductible on corporate returns). Thus, if the federal government passes a provision that increases taxes, Iowa will lose revenue. Likewise, if the provision decreases federal taxes, Iowa stands to gain revenue. Overall, the OBRA falls into the prior category, though some provisions will have a negative effect on federal revenues.

The second effect deals with the State's policy regarding "coupling", or conforming, to federal tax law. Iowa historically couples State tax law with federal tax law, though it is not constitutionally bound to do so. Coupling with federal changes that affect individuals is more common than coupling with changes that affect corporations. As a result, when the federal government raises the amount of deductions that are allowed, or changes what is included in taxable income, the State has the opportunity to conform to the changes and similarly change what is allowed in taxable income. Thus, the policy of conformity generally has the opposite effect from the policy of federal deductibility.

MAJOR PROVISIONS

There are 8 revenue provisions in OBRA that were expected to have ripple effects on State revenues. The following is a list of the tax changes, a brief explanation of each change, and effective date of enforcement. This list is not a comprehensive explanation of every tax change in OBRA.

Individual Income Tax Rate

Individual and married taxpayers will pay a new 36.0% marginal tax rate at incomes of $115,000 and $140,000 respectively. In addition, all returns that exceed $200,000 in taxable income, excluding capital gains, will pay a surtax of 10.0% on income that exceeds that threshold. A minor change in the way Alternative Minimum Tax (AMT) is calculated is included in the rate change analysis. Also included will be the effect of lifting the cap on self-employment income subject to the Medicare Hospital Insurance (HI) portion of the Social Security (FICA) tax. The AMT and rate changes are effective retroactive to January 1, 1993. The HI adjustment is effective beginning January 1, 1994.

Social Security Benefits

OBRA adds a second income tier for determining the portion of Social Security benefits that are included in taxable income. Individual Social Security recipients earning more than $34,000 in gross income will include up to 85.0% of their benefits in their taxable income. Married filers will begin paying taxes on up to 85.0% of their benefits beginning at gross incomes of $44,000. The 85.0% inclusion is intended to approximate the amount of income that is included for taxpayers with private qualified pension benefits. The Office of Management and Budget estimates that approximately 13.0% of Social Security recipients will be subject to the 85.0% inclusion. This provision will go into effect January 1, 1994.

Earned Income Tax Credit (EITC)

OBRA changes the EITC by making a full credit available at a lower amount of earned income, but phasing out the credit over a higher amount of earned income. The credit will also be allowed to workers without children, but to a much more limited extent. The federal EITC is refundable, but the Iowa EITC is not. Since many of the workers affected by this change pay little or no taxes, the effect of the inflated credit was not expected to have a large impact on state governments with tax policies in line with Iowa's. The new EITC will go into effect on January 1, 1994.

Corporate Income Tax Rate

The new corporate tax rates apply only to those corporations with federal taxable income that exceeds $10.0 million. For these corporations, a new 35.0% marginal tax rate will be applied. Additionally, a 3.0% tax will be assessed on income between $15.0 million and $18.3 million. A flat 35.0% tax rate will be collected from corporations whose taxable income exceeds $18.3 million. The number of Iowa corporations that exceed these thresholds varies dramatically from year to year. The new rates will be applied retroactively to January 1, 1993.

Expired Provisions

There are several provisions in OBRA that expired in 1992 that have been retroactively reinstated. The major provisions are the extension of employer-provided educational assistance, the targeted jobs tax credit, and the research tax credit.

Business Meals and Entertainment

OBRA raises the disallowance for these expenses from 20.0% to 50.0%. The change in these deductions is retroactive to January 1, 1993.

Corporate AMT

Currently, the AMT income (AMTI) of a corporation is increased by an amount equal to 755.0% of the amount by which Adjusted Current Earnings (ACE) exceed AMTI. A corporation generally must make 2 depreciation calculations for purposes of the AMT, one of which takes into account ACE. The OBRA eliminates the depreciation component of the ACE adjustment, so that corporations will

Impact of OBRA by Revenue Provision

Provision	Without Coupling (in millions) FY 1994	FY 1995	With Coupling (in millions) FY 1994	FY 1995
Individual Income Tax Rate	-3.9	-8.6	-3.9	-8.6
Social Security	-0.8	-3.1	3.6	14.4
EITC	0.0	0.0	0.0	-0.1
Corporate Tax Rate	0.0	-0.9	0.0	-0.9
Expired Provisions	0.5	1.5	-2.3	0.0
Business Meals, Entertainment	0.0	-1.0	0.5	5.0
Elimination of Depreciation Component of ACE	0.3	0.7	-0.7	-1.6
Small Business Expense Deduction	4.0	2.3	-8.8	-5.3
Other Provisions	0.3	0.3	-2.3	-0.5
Total	0.4	-8.8	-13.9	2.4

These effects are entirely attributable to federal deductibility.

These numbers include both the effect of State conformity to federal law as well as the effect of federal deductibility.

compute AMT depreciation using the same rules that apply to individuals. The provision is effective for property placed in service after December 31, 1993.

Small Business Expense Deduction

Currently, a small business (defined here as a business that expends less than $200,000 on new capital in a single tax year) may expense rather than depreciate $10,000 of new equipment purchases. The OBRA raises this expense level to $17,500. Because Iowa has proportionally more small businesses than the nation as a whole, it is difficult to determine the impact on State revenues by simply determining Iowa's proportional share of the federal impact. The impact illustrated below is inflated slightly to account for Iowa's unique corporate structure. The State's exposure, if it conforms to federal standards, could be considerably larger. Similarly, the windfall to the State could be much greater if the State does not conform.

BUDGET IMPACT

The effect of OBRA on State revenues in FY 1994 is expected to range between -$16.5 million and $5.0 million. The effect on FY 1995 revenues is expected to be between -$19.7 million and $14.4 million. These ranges are determined by applying best and worst case scenarios for coupling. For example, if the State coupled in every case in which revenues would be negatively affected and did not couple in every case in which revenues would be positively affected, there would be a $19.7 million loss in FY 1995. Where the impact finally rests depends on which OBRA provisions the State decides to couple.

One possible alternative would be for the State to couple all provisions in FY 1995, but not couple with any provisions in FY 1994. This would result in a $400,000 positive impact in FY 1994, and a $2.4 million positive impact in FY 1995.

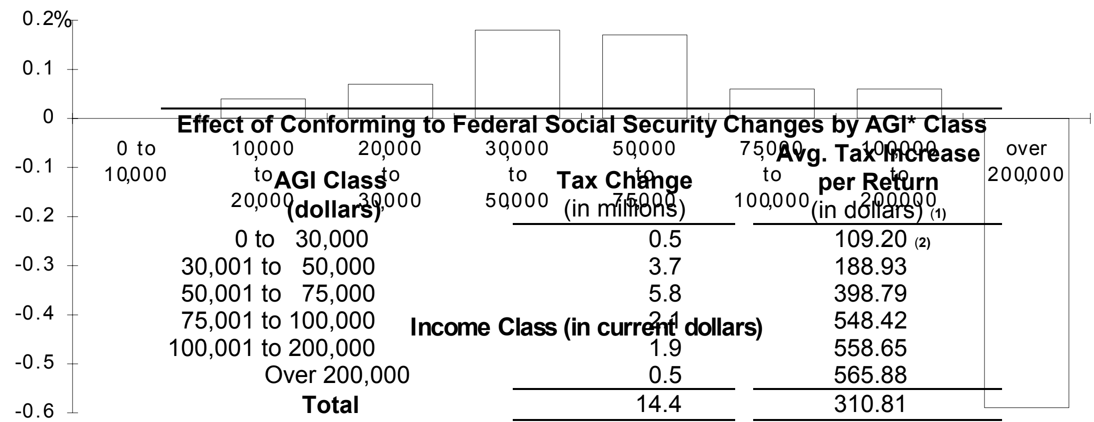
The following table illustrates the budget impact by provision.

The 2 most significant provisions are the rate change for the individual income tax and the inclusion of Social Security benefits in taxable income. The effect of the income tax rate change, which after 5 years will average approximately $11.0 million, is due entirely to federal deductibility. Because the State does not conform to federal rates, coupling will have no impact on this provision.

Federal deductibility is a regressive provision as long as federal income tax rates are progressive. As the income tax change in OBRA enhances the progressive nature of the federal income tax, the change enhances the regressive nature of federal deductibility. The following chart shows that the tax burden shifts slightly downward, as middle income classes provide a higher proportional share of State income tax revenues. Similarly, those making more than $200,000 per year can expect to pay a 0.6% smaller share of the total income tax.

The change in income tax rates, as indicated, affects only those families with incomes in excess of

Percentage Change in Tax Burden



Effect of Conforming to Federal Social Security Changes by AGI* Class

AGI Class (dollars)	**Tax Change** (in millions)	**Avg. Tax Increase per Return** (in dollars) (1)
0 to 30,000	0.5	109.20 (2)
30,001 to 50,000	3.7	188.93
50,001 to 75,000	5.8	398.79
75,001 to 100,000	2.1	548.42
100,001 to 200,000	1.9	558.65
Over 200,000	0.5	565.88
Total	14.4	310.81

*AGI - Adjusted Gross Income

1. Represents the average increase in the State tax bill of filers who experience a change in tax liability. The average tax increase for all Social Security recipients is much lower.

2. There are approximately 3,000 filers with AGI below the new thresholds, but taxable income that exceeds the thresholds. This is due to large investments accompanied by low or no wage income. Filers with taxable income in this bracket will not have any added liability.

$140,000. In actuality, the rate changes affect primarily those filers with incomes in excess of $200,000. Whereas filers with incomes between $100,000 and $200,000 will realize a 0.1% reduction in effective tax rates (due to federal deductibility), filers with incomes that exceed $200,000 will realize a 4.3% average reduction in their State tax bill.

The introduction of the second tier for calculating the inclusion of Social Security benefits affects only those who receive Social Security or Railroad Retirement benefits. The Legislative Tax Model's output indicates that if the State does not conform to federal law, approximately 40,000 filers will save approximately $85 each tax year, due to federal deductibility. If the State conforms to federal law, those individuals would have to pay an average of $438 in additional State income taxes. With the increased federal liability, a filer's average net loss to the State would be an additional $311. The following table illustrates how the burden would be spread across income classes.

DRF ESTIMATES

The DRF issued a 16 page report outlining the provisions discussed in this *Issue Review*. The report provides a comparison to current law and revenue estimates. According to the DRF, the effect of federal deductibility would be between -$6.5 million and $0.0 in FY 1994. This compares to the Legislative Fiscal Bureau (LFB) estimate of approximately $400,000. There are essentially 2 areas of divergence. Initially, the LFB estimate is a point estimate, whereas DRF provides a range. The statistical confidence levels are similar to those of the DRF, and a range of several million dollars should be considered appropriate. Secondly, the LFB estimate includes a slightly inflated effect of the small business expense deduction (see explanation under Major Provisions). The LFB estimate for the federal deductibility impact is approximately $1.8 million higher (in the positive revenue direction) than the DRF estimate. The LFB estimate for the conformity impact is approximately $10.3 million lower (in the negative revenue direction) than the DRF estimate for the small business expense deduction. It should be noted these divergences decline over time and simply reflect different appraisals of Iowa's corporate structure.

A copy of the DRF report can be obtained by contacting the Information and Management Services Division of the DRF at (515) 281-5777.

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