Options for Income Tax Simplification in Iowa

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Simplicity is generally seen as a virtue in tax systems. The National Council of State Legislatures argues that a properly functioning tax system should "facilitate taxpayer compliance by avoiding a maze of taxes, forms and filing requirements."[1] Iowa Governor Tom Vilsack has echoed this sentiment, calling for a move to a "postcard" income tax in his "Condition of the State" address on January 14. This goal is complicated, however, by the state's emerging fiscal troubles: recent estimates suggest that legislators crafting the state's fiscal year 2004 state budget must make up almost $400 million in revenues through budget cuts or tax increases.

Iowa is also facing a tax equity crisis. State policy makers have chosen to finance government services with a tax structure that requires low-income taxpayers to pay the highest effective state and local tax burdens—and allows the wealthiest taxpayers to pay the lowest effective tax rates.

This analysis looks at various tax reform options available to Iowa legislators as they seek to simplify the income tax while maintaining the short-run and long-term adequacy of state tax revenues. The analysis builds upon the tax reform options included in ITEP's September 1998 study, *Choices for Iowa: Building a Better Tax System*.[2]

Distributional Impact of the Current Iowa Tax System

In January of 2003, the Institute on Taxation and Economic Policy released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.[3] One of the findings of the study was that in 2002, Iowa had a regressive tax structure—in other words, that middle- and low-income Iowans paid a higher share of income in Iowa state and local taxes than did the better-off. In particular, the study found that:

- The poorest twenty percent of Iowans paid 10.6 percent of their income in Iowa taxes, while the wealthiest one percent of taxpayers paid only 7.9 percent of their income in state and local taxes.
- After taking account of the deductibility of state income and property taxes on federal tax forms, the effective tax rate on the wealthiest 1 percent of taxpayers was 5.8 percent—45 percent less than the tax burden on the very poorest Iowans.
- This problem has gotten worse over time. Regressive sales tax hikes and income tax cuts have resulted in a tax structure that was more regressive in 2002 than it was in 1989—the last time states entered a period of sustained fiscal shortfalls. In other words, the net impact of Iowa lawmakers' tax increase and tax-cutting behavior during the decade's cycle of fiscal shortfalls and surpluses has been to make the tax system less fair.

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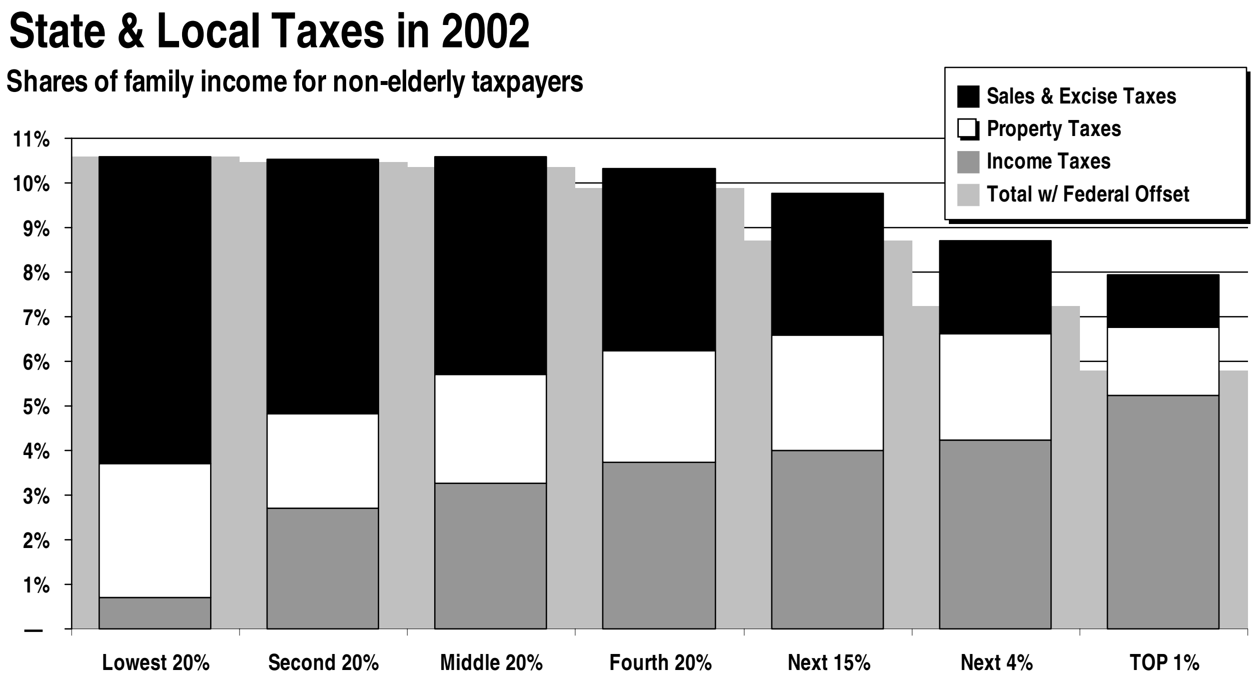
[1]National Council of State Legislatures, *Principles of a High-Quality State Revenue System*. (2001) Available at http://www.ncsl.org/programs/fiscal/fpphqsrs.htm.

[2]*Choices for Iowa: Building a Better Tax System*. Slocum, Lynch, Ettlinger, Gardner. (Institute on Taxation and Economic Policy, 1998). The original 1998 study can be found on ITEP's website at www.itepnet.org.

[3]*Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. McIntyre, Denk, Francis, Gardner, Hsu and Sims (Institute on Taxation and Economic Policy, 2003).



Complexity and the Iowa Income Tax

Almost all of the states that levy personal income taxes in 2003 have taken one important step toward simplifying their tax structure—linking the tax base to the federal income tax. This has obvious appeal from a tax administration perspective: since most taxpayers have to determine their adjusted gross income on their federal tax forms, state policy makers can minimize the administrative burden to Iowans by allowing them to copy a single number from the federal form. Of the 41 states with a broad-based income tax, all but five currently tie their tax base to the federal tax base in this way.

There is, however, wide variation in the complexity of income tax rules among these states. The closest approach to a "postcard" income tax is one that simply takes a flat **percentage of federal tax**. Currently, only North Dakota allows taxpayers to calculate their income tax in this way.[4] A slightly more complicated approach starts with **federal taxable income**, which includes generous federal personal exemptions and standard deductions but allows a state to apply a different rate structure and different credits.

The most common approach to linking state and federal tax bases, however, is the use of **federal adjusted gross income (AGI)** as a starting point for state income tax calculations. This is the approach taken by Iowa. States that start with federal adjusted gross income have greater leeway to allow special targeted tax deductions or exemptions, and usually do so.

The Iowa income tax is more complex than most, primarily because of the variety of ways in which the state's income tax base departs from federal AGI. Iowa allows special deductions and exemptions for federal income tax payments, capital gains, pension benefits and Social Security income.

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[4]North Dakota taxpayers are allowed the option of calculating their income tax as a percentage of federal income tax. In the wake of federal income tax rate cuts enacted in 2001, North Dakota lawmakers avoided the impact of these cuts by using a rate structure equivalent to the pre-2001 federal tax rates.

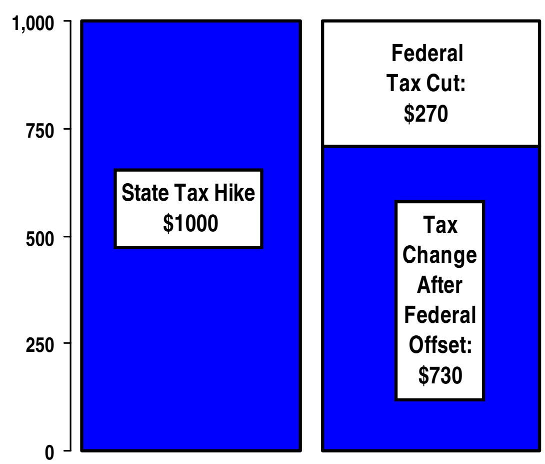
The Iowa tax system is also complicated by the optional "married filing separately" approach to filing tax forms. Most states apply wider tax brackets to married couples than to single filers in order to avoid a "marriage penalty" through which two workers would pay more income taxes as a married couple than they would as single taxpayers filing separately. Iowa, by contrast, avoids the "marriage penalty" by allowing married couples to file their taxes separately on the same form—and then applies exactly the same tax brackets to all filing types, single or married. This approach adds to the complexity of the tax system by requiring married taxpayers who choose the separate filing option to recalculate taxable income and deductions, instead of simply copying numbers from their federal tax forms.

Options for Income Tax Simplification

Tax simplification is generally touted as a means of lessening the administrative burden on taxpayers and tax administrators. But the current complexity of the Iowa income tax structure is a blessing in disguise for another reason: by eliminating various poorly designed tax loopholes, Iowa lawmakers can simplify the state income tax base and increase revenues to cover fiscal shortfalls—without raising tax rates. This section describes a variety of tax simplification options available to Iowans, and contrasts the impact of these options to a "flat-tax" option which flattens the tax rate structure without substantially simplifying the tax code.

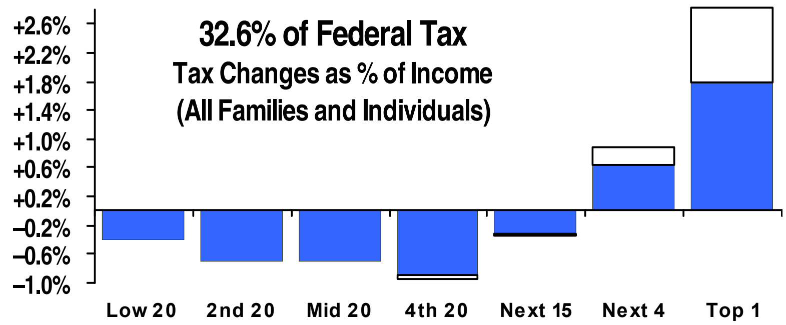
For each option described below, the accompanying bar charts show the impact of these options on each Iowa income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent bar shows each proposal's effect *before* consideration of federal tax changes. We have presented our data in this way because for those Iowans who itemize deductions on their federal tax return, changes in state income taxes can produce offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Iowans, including federal and state taxes. The following example shows how to interpret these charts.

Suppose an itemizing Iowa taxpayer in the 27 percent federal tax bracket is subject to a $1,000 increase in Iowa income taxes. The value of her federal itemized deductions will increase by $1,000. This means that $1,000 *less* of this taxpayer's income will be subject to federal tax after the Iowa tax cut. Since this last increment of income was originally taxed at 27 percent, this person's federal tax liability decreases by $270. So the net *overall* tax hike for this itemizing Iowa taxpayer from a $1,000 hike in state tax liability is actually $730, not $1000. Our distributional analysis of this proposal (the second column in the chart at right) shows that taxpayers do not pay the full $1,000 tax hike, since $270 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the additional tax burden on Iowans from this proposal.



1. Impose a Flat "Percentage of Federal" Income Tax

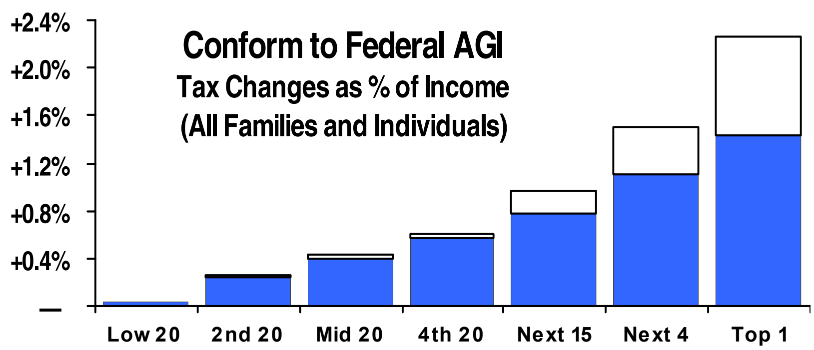
One easy way to move toward Gov. Vilsack's "postcard" ideal is the "percentage of federal" income tax, currently used in North Dakota. Under this approach, taxpayers take their actual federal income tax amounts from the federal form 1040 and multiply this amount by a flat percentage rate to yield the Iowa income tax amount. ITEP estimates that in 2002, a flat tax rate of 32.6 percent of federal tax would yield approximately the same revenue as the current Iowa income tax. The chart at right shows the distributional impact of such a change.



- Although the proposal would leave Iowa tax collections unchanged in 2002, the overall *federal* tax burden on Iowans would actually decline by $96 million, because federal itemizers living in Iowa would be able to deduct larger amounts of state income tax. In other words, Iowa taxpayers overall would receive $96 million in tax cuts at no cost to the state—an important consideration given the state's dire fiscal situation.
- Ninety five percent of Iowans would, on average, see state income tax cuts as a result of this change.

2. Conform to Federal Adjusted Gross Income

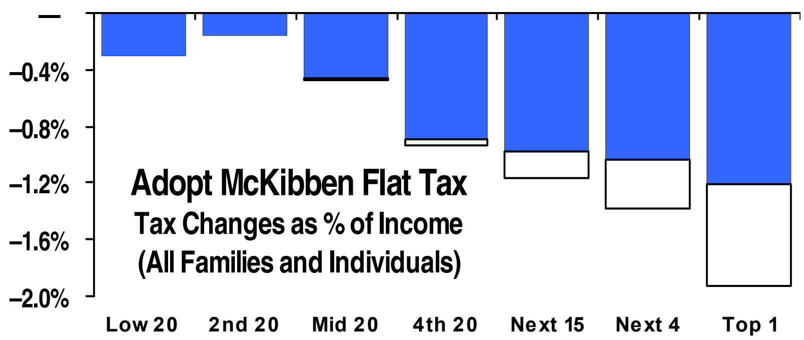
Although Iowa's income tax forms begin with federal adjusted gross income, certain taxpayers are allowed special tax deductions or exemptions for particular types of income. Iowa could simplify its tax forms substantially by eliminating these loopholes and conforming more closely to federal AGI. The option modeled here eliminates the deduction for federal income taxes paid, the capital gains deduction, and the pension exclusion, and conforms taxation of Social Security benefits to federal tax rules.



- Because this proposal would eliminate several expensive tax loopholes, Iowa income tax collections would increase by more than $640 million under this proposal. Yet $148 million of this added revenue—almost 25 percent of the total—would be paid not by Iowans but by the federal government in the form of lower federal income taxes for itemizers.
- Less than nine percent of the added state tax burden would be paid by low- and middle-income Iowans.

3. Adopt McKibben 3.5% "Flat Tax" Plan

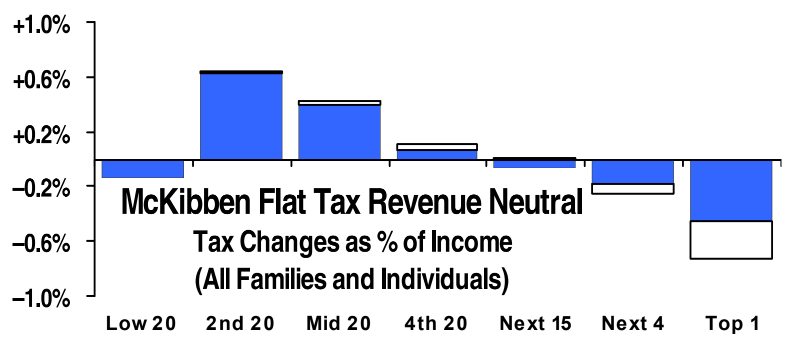
This option repeals the federal income tax deduction and institutes a single flat-rate tax of 3.5 percent. This option also repeals the deduction for federal income taxes paid. Unlike the "conformity" options detailed above, which reduce the number of calculations Iowa taxpayers must make in order to calculate Iowa taxable income, this plan further diverges from federal AGI by completely exempting pension and Social Security income from taxation. This plan also eliminates all itemized deductions, increases the standard deduction and adds income limits to the personal exemption credit. Finally, the plan increases filing thresholds to $11,000 for single filers and $15,000 for all others. The plan contains elements that make the tax system more simple (for example, eliminating itemized deductions and the federal income tax deduction), elements that make the tax system more complicated (adding income limits to the personal exemption credit), and elements that do not affect the simplicity of the tax (for example, changing from a graduated rate structure to a single flat rate).



- The plan's impact is clearly regressive. While all income groups receive, on average, an income tax cut, that cut is smallest as a percentage of income for low- and middle-income Iowans.
- Almost a fifth of the state revenue losses from this plan would never be received by Iowa taxpayers in tax cuts, but would be offset by federal income tax hikes.

4. Revenue-Neutral Version of McKibben Plan

This option makes one important modification to the "flat tax" proposal described above—the imposition of a higher single tax rate, designed to leave Iowa tax collections unchanged. This is an important consideration at a time when fiscal shortfalls could make state tax cuts unaffordable. Because the plan preserves the increased tax thresholds from the original McKibben plan, low-income taxpayers see a small tax cut under this option.

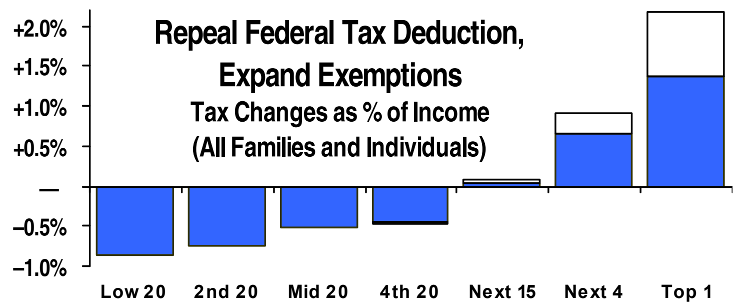


- This option results in a regressive tax hike for most Iowans—and a net tax cut for the wealthiest 20 percent of Iowa taxpayers.
- While Iowa tax collections would remain unchanged, federal income taxes paid by Iowans would *increase* by $20 million. This is because wealthier Iowans would have less state income tax to deduct on their federal forms.
- The biggest single beneficiary of this proposal—the wealthiest one percent of Iowa

taxpayers, with an average income of $634,000 in 2002—would receive an average state income tax cut of more than $12,000 from this plan. But the deductibility of state income taxes on federal forms means that 37 percent of the state income tax cuts accruing to this wealthiest group would be claimed directly by the federal government in the form of higher federal income taxes.

5. Repeal Deduction for Federal Income Taxes, Increase Deductions and Credits

This option uses the revenues from repealing the federal income tax deduction to fund an expansion of various low-income deductions and credits. The Earned Income Tax Credit is made refundable and expanded to 10 percent of the federal credit, while standard deductions are conformed to the federal amount. Iowa's personal exemption credit is repealed and replaced with a personal and dependent exemption that conforms to the federal amount. The plan takes advantage of the federal deductibility of state income taxes to raise almost $100 million for the state—at no cost to Iowa taxpayers. The added state income tax revenues are offset by $100 million in federal income tax cuts—which means that the total amount of taxes paid by Iowans is unchanged.



- This option increases Iowa tax revenues by $100 million—but leaves the net tax burden on Iowans unchanged.
- This approach make the income tax simpler because it conforms Iowa taxable income more closely to federal taxable income.
- Eighty percent of Iowans receive, on average, a tax cut from this option.

Summary

Iowa faces a short-term fiscal challenge. State policymakers must decide how best to modify the state's tax structure to make up the state's current $400 million revenue shortfall, while ensuring the long-term adequacy of the tax structure.

Iowa also faces a tax equity crisis: ITEP's recent *Who Pays* study found that Iowa's tax system is regressive, applying the very highest effective tax rates to the poorest Iowans.

In this context, simplifying the Iowa personal income tax might seem a daunting task. Yet, as this analysis has shown, meaningful income tax simplification can be achieved in a way that simultaneously advances the important goals of tax adequacy and tax equity. Simplification can, of course, be pursued in a way that leaves total Iowa income taxes unchanged—but these "loophole-closing" measures can also be used to help raise revenues at a time when such revenues are desperately needed.

Some of the options modeled here, by contrast, achieve none of these goals. In particular, replacing the Iowa income tax with a "flat tax" structure does nothing to simplify the tax system—since tax tables are as easy to use under a graduated tax as under a flat-rate tax—and makes the tax system more regressive. In fact, the "flat tax" proposals described in this analysis contain provisions that would make the tax system more complicated as well as provisions that would simplify the tax structure—but the choice of a flat income tax rate in itself does nothing for the goal of tax simplification.

Options for Iowa Income Tax Simplification

All Iowa Taxpayers, 2002

Income Range	Less Than $14,000	$14,000 – $29,000	$29,000 – $44,000	$44,000 – $67,000	$67,000 – $117,000	$117,000 – $270,000	$270,000 – Or More
Average Income in Group	$8,500	$21,100	$35,700	$55,100	$85,400	$158,000	$633,900

32.6% of Federal Income Tax

Tax Change as % of Income	–0.4%	–0.7%	–0.7%	–0.9%	–0.3%	+0.9%	+2.8%
$ Average State Tax Change	$ –33	$ –148	$ –250	$ –516	$ –298	$ +1,417	$ +17,934
$ Average Federal Tax Change	$ —	$ +1	$ +3	$ +32	$ +34	$ –393	$ –6,679
$ Average Net Tax Change	$ –33	$ –147	$ –247	$ –485	$ –264	$ +1,024	$ +11,255

Conform to federal AGI

Tax Change as % of Income	+0.0%	+0.3%	+0.4%	+0.6%	+1.0%	+1.5%	+2.3%
$ Average Tax Change	$ +3	$ +53	$ +155	$ +336	$ +828	$ +2,371	$ +14,384
$ Average Federal Tax Change	$ —	$ –0	$ –11	$ –19	$ –162	$ –628	$ –5,322
$ Average Net Tax Change	$ +3	$ +53	$ +145	$ +316	$ +666	$ +1,743	$ +9,063

Adopt McKibben Flat Tax

Tax Change as % of Income	–0.3%	–0.2%	–0.5%	–0.9%	–1.2%	–1.4%	–1.9%
$ Average Tax Change	$ –25	$ –33	$ –167	$ –513	$ –996	$ –2,193	$ –12,246
$ Average Federal Tax Change	$ —	$ –1	$ +4	$ +18	$ +161	$ +554	$ +4,626
$ Average Net Tax Change	$ –25	$ –35	$ –163	$ –494	$ –835	$ –1,639	$ –7,620

Revenue-Neutral Version of McKibben Flat Tax

Tax Change as % of Income	–0.1%	+0.6%	+0.4%	+0.1%	–0.0%	–0.2%	–0.7%
$ Average Tax Change	$ –12	$ +135	$ +149	$ +56	$ –39	$ –390	$ –4,642
$ Average Federal Tax Change	$ —	$ –2	$ –10	$ –19	$ –12	$ +111	$ +1,765
$ Average Net Tax Change	$ –12	$ +132	$ +139	$ +38	$ –50	$ –280	$ –2,877

Repeal Federal Income Tax Deduction, Increase Deductions and Credits

Tax Change as % of Income	–0.9%	–0.8%	–0.5%	–0.5%	+0.1%	+0.9%	+2.2%
$ Average Tax Change	$ –73	$ –159	$ –180	$ –260	$ +71	$ +1,433	$ +13,770
$ Average Federal Tax Change	$ —	$ +0	$ –0	$ +9	$ –38	$ –398	$ –5,122
$ Average Net Tax Change	$ –73	$ –159	$ –180	$ –251	$ +33	$ +1,035	$ +8,648

SOURCE: Institute on Taxation and Economic Policy, March 2003

Appendix II: The Impact of the Deduction for Federal Income Taxes Paid

Each of the tax reform options modeled in this analysis includes the repeal of Iowa's state income tax deduction for federal income taxes paid. Iowa is one of only nine states that allow taxpayers to deduct federal income taxes from state taxable income, and one of only three states to allow taxpayers to deduct the full amount of federal income taxes paid. This deduction is one of the most expensive tax loopholes allowed from Iowa personal income taxes—and one of the most regressive. The following table shows the distributional effects of the deduction as it is currently structured.

Impact of the Deduction for Federal Income Taxes
Iowa Residents by Income Group, 2002

Income Group	Tax Cut as % of Income	Average Tax Cut	Percent of Total Tax Cut
Lowest 20%	0.0%	$ (3)	0%
Second 20%	-0.2%	$ (45)	2%
Middle 20%	-0.3%	$ (115)	5%
Fourth 20%	-0.5%	$ (265)	13%
Next 15%	-0.8%	$ (725)	26%
Next 4%	-1.4%	$ (2,140)	20%
Top 1%	-2.2%	$ (13,892)	33%

Source: ITEP Microsimulation Tax Model, March 2003

- The very wealthiest one percent of Iowa taxpayers receive 33 percent of the benefits from this tax break, for an average 2002 state tax break of almost $13,900.
- The very poorest Iowans—the twenty percent of taxpayers with income less than $12,000 in 2002—receive an average tax break of $3 from the deduction for federal income taxes.
- The poorest eighty percent of Iowa taxpayers receive less than 20 percent of the tax benefit from this exclusion in 2002, with the remaining 80 percent accruing to the wealthiest twenty percent of Iowans.

The skewed distribution of the tax break for federal income tax payments is due to the fact that better-off people pay more in federal personal income taxes than middle- and low-income taxpayers.

Most Americans, of course, actually pay less in federal personal income taxes than in other federal taxes such as the regressive excise and payroll taxes. For more than three-quarters of Americans, the most effective way to avoid "double taxation" would be to allow a deduction for federal payroll taxes paid. Yet Iowa allows this deduction only for the federal income taxes paid primarily by wealthier taxpayers.

APPENDIX III: ITEP METHODOLOGY

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:
IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey: Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources:
Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP Internet site at www.itepnet.org.