

# POLICY REPORT

**The Iowa Policy Project**

**Child & Family Policy Center**

FOR RELEASE 1:30 P.M. CST, FRIDAY, MARCH 14, 2003  
CONTACT: Mike Owen (319) 643-3628 ipp@lcom.net

## Flat Taxes: Not So Simple

### Study Shows Tax-Rate Disparities Effects of Proposed Changes in Iowa Tax Policy

DES MOINES, Iowa (March 14, 2003) – Moves to simplify Iowa taxes in some cases may not only fail to make filing simple, but also may raise new fairness and revenue issues, a new study noted today.

At the request of two Iowa policy organizations, the Institute on Taxation and Economic Policy in Washington, D.C., analyzed five options to simplify Iowa taxes, including a proposal for a 3.5 percent flat-rate income tax. Gov. Tom Vilsack recommended tax simplification in his Condition of the State address Jan. 14.

“In the process of simplifying Iowa’s tax system we must avoid doing any harm to working families and their children. The 3.5 percent flat income tax proposal does not avoid doing that harm,” said Victor Elias, senior associate with the Child and Family Policy Center in Des Moines.

Elias and Peter Fisher, research director of the Iowa Policy Project, noted particular concerns about the flat-tax proposal. They noted that plan, advanced by State Sen. Larry McKibben of Marshalltown, is estimated to cost the state about \$520 million when fully implemented, with the state already facing a projected shortfall of up to \$400 million.

“It’s essential to look at income-tax changes in the context of all state and local taxes in Iowa,” Fisher said. “While some proponents of a flat-tax argue that everyone should pay the same percentage of income in taxes, adopting a flat income tax moves Iowa farther away from that goal, not closer. The current state tax system takes a smaller percentage of income from high-income taxpayers than from low- and middle-income taxpayers. Moving to a flat-rate income tax would increase that disparity.”

Fisher added, “If the idea is to simplify Iowa taxes, the flat-tax proposal doesn’t really do that. Just using one flat rate makes filing no more simple than applying a graduated rate to a given amount of income.”

The review of tax-simplification ideas is the first in a series of tax-plan analyses being presented by IPP and CFPC, with the assistance of the ITEP, as Iowa’s legislators and Gov. Vilsack search for answers to the state’s fiscal dilemma.

According to the ITEP report, the proposed 3.5 percent flat tax would give tax cuts to all income groups, but in a largely regressive manner – favoring higher-income earners, as a proportion of their income, compared with low- and middle-income earners.

-- more --

“One of the most regressive features of the McKibben plan is the expansion of Iowa’s current exemptions for Social Security and pension income. Under McKibben’s bill, the wealthiest recipients of retirement income would now be completely exempt from tax on that income,” Fisher said, noting other recipients are already fully exempt. “As a result, the most well-off retirees would pay far less income taxes than working families with the same income.”

In addition, a portion of the tax savings is an illusion, as less in state taxes could be deducted for federal tax purposes. For example, while the wealthiest 1 percent of income-earners would have the largest benefits as a share of income, more than one-third of their average savings (\$4,626 of \$12,246) under the McKibben plan would go to the federal government.

The ITEP report also found:

■ Even making the flat-tax proposal revenue-neutral – no loss of revenue to the state – the effect also would be largely regressive. While the lowest 20 percent of income earners would save an average of \$12 (0.1 percent cut), those in the highest 1 percent would save \$2,877 on average (0.7 percent cut). The middle 60 percent of income earners – people making from \$14,000 to \$67,000 in 2002 – would see a net tax increase.

■ A flat “percentage of federal” income tax would be one way to move toward Gov. Vilsack’s proposal for a “postcard” tax return. That system is used in North Dakota. In 2002, a flat tax rate of 32.6 percent of federal tax would yield about the same revenue as the current Iowa income tax – but result in an overall tax cut of \$96 million for Iowans. Under this proposal, all but the top 5 percent of income earners would, on average, see state income tax cuts.

“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,” the report said.

■ Eliminating loopholes and more closely conforming to the federal adjusted gross income also would be simpler, and would raise income-tax collections by more than \$640 million – about 25 percent of which would be paid by the federal government in the form of lower federal taxes for itemizers. This proposal would raise taxes, with less than 9 percent of the added burden paid by low- and middle-income Iowans.

■ Repealing the federal income tax deduction to fund an expansion of low-income deductions and credits would increase Iowa tax revenues by \$100 million. It would leave the net tax burden on Iowans unchanged overall because federal income taxes paid by Iowans would decline by \$100 million. This plan would result in a tax cut, on average, for the lowest-earning 80 percent (those making \$67,000 and under).

The Iowa Policy Project is a non-profit, non-partisan research organization that engages scholars at Iowa’s public and private colleges and universities to research issues of importance to the citizens of Iowa. IPP reports are on the web at [www.iowapolicyproject.org](http://www.iowapolicyproject.org).

The Child & Family Policy Center was established in 1989 “to better link research and policy on issues vital to children and families.” CFPC publications are on the web at [www.cfpciowa.org](http://www.cfpciowa.org).

The Institute on Taxation and Economic Policy website is [www.itepnet.org](http://www.itepnet.org).