The Iowa Policy Project Child & Family Policy Center

FOR IMMEDIATE RELEASE – TUESDAY, APRIL 29, 2003
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Who Pays with Cigarette Tax Hike, New Income Tax Cuts

Report Shows Impacts of Potential Iowa Tax Changes

DES MOINES, Iowa (April 29, 2003) – Reducing taxes on retirement plan income to compensate for a cigarette tax increase would present new equity problems with Iowa taxes, but policy makers could ease those problems with other alternatives, a new report noted today.

While cigarette taxes carry the benefit of reducing smoking, the report showed they also treat low- and middle-income smokers more harshly than high-income smokers as a percentage of income.

"As a tax on consumption, cigarette taxes are regressive. There are ways, however, to offset the tax effects on income classes as a whole so that a cigarette tax will not increase the overall tax burden on low- and middle-income taxpayers," said Charles Bruner, executive director of the Child & Family Policy Center in Des Moines.

Bruner and Peter S. Fisher, research director of the Iowa Policy Project and a University of Iowa planning professor, reported on an analysis by the Institute on Taxation and Economic Policy of the impact of a potential 75-cent increase in the cigarette tax, and how it would affect Iowans at different income levels.

At various points during the current legislative session, some members have supported raising the cigarette tax as a source of revenue for various purposes – and by varying amounts. Iowa's current tax is 36 cents per pack. Some have called for doubling the tax, and some have proposed larger increases. The Iowa Health Initiative has proposed a $1 increase.

The new report examines the effect of using a new cigarette tax increase to finance income-tax reductions – a full exemption of retirement income, which would help primarily wealthy taxpayers, and an increase in personal exemption credits and the Earned Income Tax Credit, which would lessen the impact to Iowans with lower and moderate incomes.

"We think serious consideration should be given to alternative forms of tax relief that would offset the regressivity of the cigarette tax change instead of aggravating it," Fisher said.

Besides the income-group analysis, Bruner and Fisher analyzed the proposals in the context of seven tax principles under which all tax policies and proposals could be evaluated.

Among highlights of the report and the ITEP analysis:

■ Coupling the cigarette tax increase with a reduction of income taxes on pension and Social Security income would benefit primarily higher income retirees. That is because lower and middle-income retirees already pay little or no Iowa tax on retirement income.

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As an example, elderly taxpayers with incomes below $30,000 would save only $6 per year on average, and those with incomes of $30,000 to $50,000 would save just $158. Although those two groups account for 56 percent of elderly taxpayers, they would receive only 14 percent of the savings. By contrast, the average tax savings for those with incomes between $50,000 and $75,000 would be $629, and for those making $100,000 or more, the average would be $1,730.

"The top 19 percent of elderly income earners would receive 57 percent of the tax cut," Fisher said.

■ Complete exemption of Social Security and pensions from taxes would cost the state about $169 million per year, and would require a $1 increase in the cigarette tax, with no revenue left for other purposes.

■ A 75-cent cigarette tax increase would affect people of all income groups in 2002 in a range from $80 to $124 per year. To someone in the lowest 20 percent of income earners – making less than $14,000 – the average increase of $80 represents close to 1 percent of income. For those with incomes above $67,000, it would be on average only about one-tenth of 1 percent.

■ Increasing personal exemption credits by $25 and expanding the Earned Income Tax Credit from 6.5 percent to 20 percent of the federal "would do a great deal to offset the regressivity" of a 75-cent cigarette tax increase.

"This option would leave about $44 million annually to fund other projects," the report said, adding that if it were used entirely to repay debt for Gov. Tom Vilsack's proposed Iowa Values Fund, it would support a bond issue of about $550 million.

The six-page full report is available on the web at www.iowapolicyproject.org.

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.

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.

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For more information about the effects of eliminating all taxes on Social Security benefits, see the Iowa Policy Project Policy Brief, "Expanding the Social Security Benefit Exemption Under the Iowa Income Tax," available at www.iowapolicyproject.org.