Iowa Fiscal Partnership *backgrounder*
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A MATTER OF FAIRNESS

How Expanding Iowa's EITC Can Improve Tax Fairness

One of the most basic principles in developing tax policy is "fairness." Taxes should be fair in treating similar taxpayers in a similar fashion (lateral tax fairness or equity) and taxes should be fair based on an ability to pay (vertical tax fairness or equity).

On issues of tax fairness, Iowa's personal income tax system falls most short in its tax treatment of families with children. In fact, Iowa's income tax system is the most skewed against families with children of any state income tax system in the country.

Tax experts agree that, particularly in establishing personal income taxes, the minimum income required to meet basic household needs should not be taxed. Households of different sizes have different basic needs. Personal exemptions, personal tax credits and standard deductions all have been employed to recognize these basic needs. The U.S. Department of Agriculture estimates the minimum basic cost of raising a child is $7,988 annually, a cost that should be reflected in the personal exemptions and tax credits provided in an income tax. The federal government, through both a personal exemption and a child and dependent tax credit, essentially provides for this amount of recognition. Iowa does not.

Compared with the federal income tax system, Iowa provides almost no recognition of the cost of raising a family (Table 1).

Table 1. Iowa Tax Code Doesn't Recognize Family Costs
U.S., Iowa Tax Treatment of Households with Dependents

	Federal	*Iowa*
Standard Deduction		
Single individual	$ 5,250	$ 1,700
Married couple	$ 10,700	$ 4,200
Single head of household	$ 7,800	$ 4,200
Personal Exemption	$ 3,400 per child/adult	– none –
Child/Dependent Credit	$ 1,000 per child	$ 40/child
Maximum EITC		
No children	$ 428	$ 30
One child	$ 2,853	$ 200
Two or more children	$ 4,716	$ 330

The result of this lack of recognition is that a large number of working Iowa families who have no federal tax liability (and receive a federal Earned Income Tax Credit) must turn around and pay significant state income taxes, even though they are struggling to make ends meet. The family in the box on page 2 is one such illustration.

Table 2 provides tax threshold information on when different Iowa taxpayers begin paying Iowa and federal income taxes. As Table 2 shows, Iowa provides very preferential tax treatment for retired individuals, excluding most from state tax liability. At the same time, Iowa taxes over 70,000 working Iowa families with children that the federal government determines are too poor to tax. This unfair tax treatment of families with children extends to middle and upper-middle income families, as well.

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A family of four making $60,000 per year actually pays more state income taxes than a childless married couple family making the same $60,000 per year. The childless couple pays more federal income tax because they do not have child-raising costs and therefore receive no child deductions. Fewer deductions mean more federal tax for those people. However, this allows them to deduct more federal taxes on their state income-tax return than the couple with children and pay less state income tax as a result.

Addressing these tax inequities and making Iowa's tax system fair for families with children ultimately requires fundamental changes to Iowa's tax system that would also simplify Iowa's income tax:

- Adopting federal definitions of the standard deduction and personal exemptions.
- Increasing the state child and dependent credit from $40 to $200.
- Raising the state Earned Income Tax Credit from 7 percent of the federal credit up to 30 percent of the credit.
- Creating expanded tax brackets for married couples and requiring joint filing.
- Eliminating federal deductibility (see IFP report: *Iowa's Personal Income Tax: Reform for Iowans at Any Age*).

PAYING MORE IN IOWA

This hypothetical Iowa couple has two young children. One parent works full time as a counselor for delinquent youth, making $18,000 per year, while the other works three-quarters' time as a nurse's aide, making $12,000. They pay $650 per month for an apartment and pinch pennies to make ends meet, juggling their schedules to allow one to be at home with their children, which minimizes child-care costs. They look forward to tax time, as they can count on the federal Earned Income Tax Credit to provide them a refund they can put aside for a rainy day.

What they don't expect is to have to put some of that back paying state income taxes. In the end, while this couple receives $2,060 back from the federal government from the EITC, they must turn around and pay the state of Iowa $636 in state income taxes.

Even in the short term, however, Iowa lawmakers can make changes that will address those working Iowa families with children who are most disadvantaged. Increasing the Iowa Earned Income Tax Credit from 7 percent to 12 percent, which could be financed by setting a ceiling on the amount of capital gains that can be sheltered from taxation, would provide substantial benefits to 170,000 families like the family described above.

Table 2. Iowa's Tax Thresholds Benefit Retirees
U.S., Iowa Personal Income Tax Thresholds, 2006

	Federal	*Iowa*
Single individual	$ 10,045	$ 9,001
Single retiree	$ 21,705	$ 30,001*
Married couple, no children	$ 16,905	$ 14,397
Married couple, two children	$ 41,870	$ 19,562
Retired couple, no children	$ 29,905	$ 37,342**
Single parent, one child	$ 28,324	$ 16,622

* *$34,334 in 2007*
** *$42,890 in 2007*