

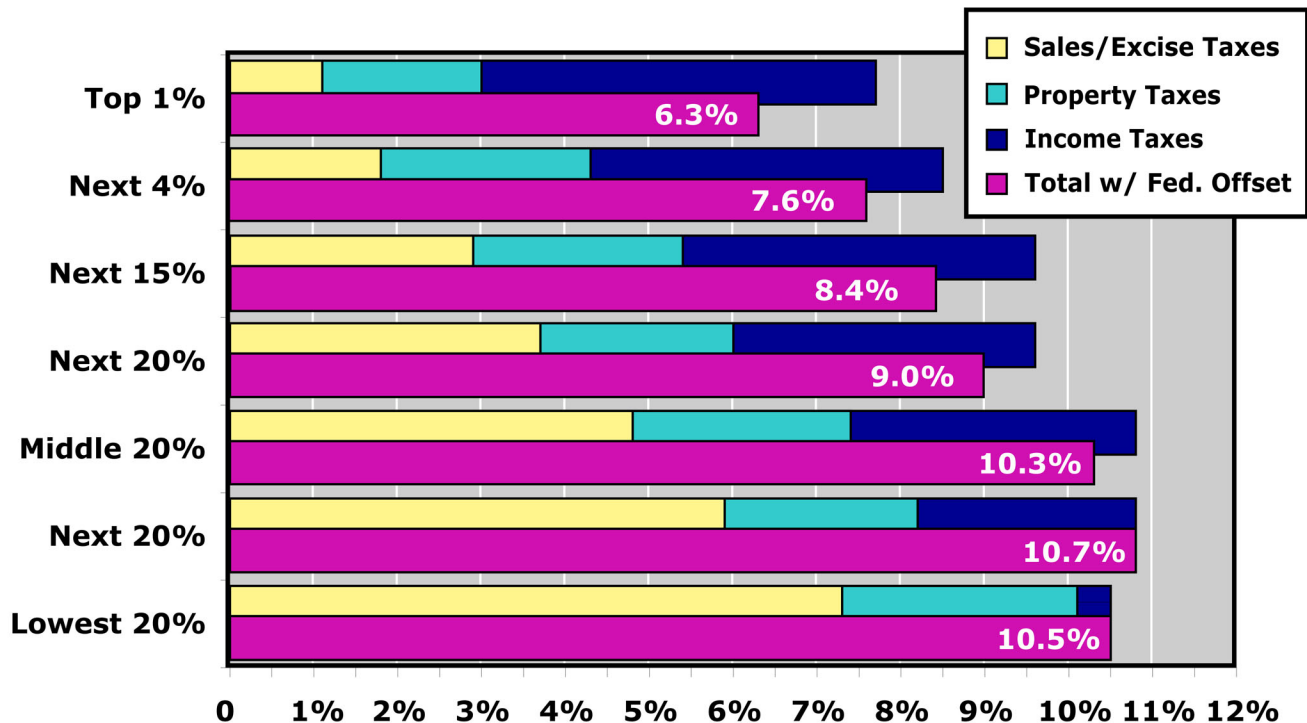
WHO PAYS IOWA TAXES?

As Share of Income, Lower-Income Iowans Pay the Most

Lower-income non-elderly households in Iowa pay a disproportionate share of their income in state and local taxes. New data from the Institute on Taxation and Economic Policy (ITEP) establish a continuing problem of fairness in Iowa’s tax code: Those who earn less income can expect to pay a larger share of it in state and local taxes than those who make more. For the 60 percent of non-elderly taxpayers in Iowa who earn less than \$50,000, the combination of sales and excise taxes, property taxes and income taxes together amount to well over 10 percent of total income. By contrast, the top 5 percent of taxpayers, earning over \$127,000, on average pay about 7.6 percent or less of their income in state and local taxes.

Each of the three major taxes that make up Iowa’s state and local tax system has a different impact when considered alone, but must be considered together in order to evaluate the total effect of Iowa’s tax structure. Further, an accurate assessment of that impact must consider the net effect after federal tax deductions for those state and local taxes — the “federal deduction offset” included in Figure 1 and Table 1, and described on page 2.

Figure 1. Iowa’s State & Local Taxes Favor High-Income Earners



Source: Institute on Taxation and Economic Policy, 2008

The Iowa Policy Project

20 E. Market St.
Iowa City, IA 52245
(319) 338-0773 • www.iowapolicyproject.org

CHILD & FAMILY POLICY CENTER

1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

Table 1. Iowa's State & Local Taxes Favor High-Income Earners
Taxes by Share of Income, Non-Elderly Taxpayers*

Income Group	Lowest 20%	Next 20%	Middle 20%	Next 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than \$16,000	\$16,000- \$33,000	\$33,000- \$50,000	\$50,000- \$78,000	\$78,000- \$127,000	\$127,000- \$320,000	\$320,000- plus
Avg Income	\$8,600	\$24,500	\$41,300	\$62,600	\$96,500	\$183,800	\$831,100
Sales/Excise Taxes	7.3%	5.9%	4.8%	3.7%	2.9%	1.8%	1.1%
<i>General Sales-Individuals</i>	4.2%	3.6%	3.1%	2.5%	2.0%	1.2%	0.8%
<i>Other Sales & Excise-Ind.</i>	1.5%	0.9%	0.7%	0.5%	0.3%	0.2%	0.1%
<i>Sales & Excise on Business</i>	1.6%	1.3%	1.0%	0.8%	0.6%	0.4%	0.2%
Property Taxes	2.8%	2.3%	2.6%	2.3%	2.5%	2.5%	1.9%
<i>Property Taxes on Families</i>	2.6%	2.1%	2.4%	2.1%	2.3%	1.9%	0.8%
<i>Other Property Taxes</i>	0.2%	0.2%	0.1%	0.2%	0.2%	0.6%	1.2%
Income Taxes	0.4%	2.6%	3.4%	3.6%	4.2%	4.2%	4.7%
<i>Personal Income Tax</i>	0.4%	2.6%	3.4%	3.6%	4.2%	4.1%	4.5%
<i>Corporate Income Tax</i>	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%
Total Taxes	10.5%	10.7%	10.8%	9.7%	9.7%	8.4%	7.7%
Federal Deduction Offset	0.0%	0.0%	0.4%	0.8%	1.3%	0.8%	1.4%
Total With Federal Offset**	10.5%	10.7%	10.3%	9.0%	8.4%	7.6%	6.3%

* Estimates calculated using 2006 income data under 2008 tax law.

**See Federal Offset section of this background for explanation (page 3).

Source: Institute on Taxation and Economic Policy, 2008

Progressive and Regressive Taxes in Iowa

Iowa's system offers examples of all three typical labels used to describe how taxes affect people at different incomes: "regressive" taxes, which take a larger share of the incomes of those who have the least than of those with greater ability to pay; "proportional" taxes, which affect a similar share of income for all taxpayers; and "progressive" taxes, which increase as a share of the taxpayer's rising income. Policy trends in the state — toward increases in the sales and property taxes and cuts in the income tax — have produced a system that expects more from the household budgets of low- and moderate-income taxpayers than from their higher-income neighbors.

Sales and excise taxes are steeply regressive.¹ The 20 percent of Iowa taxpayers with the lowest income pay 7.3 percent of their income on these taxes, while those in the top 1 percent pay only 1.1 percent. Though the sales tax exempts most basic necessities (i.e. food, health care, prescription drugs and utilities), many necessary items remain taxable: clothing, non-prescription medication, and grooming and hygiene products, for example. Because a bigger portion of low-income Iowans' income is spent purchasing basic necessities and other items, the sales tax remains quite regressive.

Property taxes, meanwhile, are fairly proportional as a share of income for most taxpayers. Between 2.3 percent and 2.8 percent of income goes to property taxes for all but the top 1 percent of Iowa taxpayers by income, on average. There is a drop-off at the top 1 percent, with those taxpayers paying just 1.9 percent of their income in property taxes.

Of the three major taxes that make up our state and local tax system, only the income tax is progressive. The lowest-income 20 percent (people making less than \$16,000) pay four-tenths of 1 percent of their income in state and local income tax while the top 1 percent (making over \$320,000) pay 4.7 percent.

Federal Offset

Data from ITEP also show the effective total state and local tax rate in Iowa after the “federal deduction offset.” Both income and property taxes are deductible on a person’s federal income-tax return.² For those who itemize deductions, income and property taxes paid in Iowa are partly offset by a reduction in federal income taxes. Including the federal offset that occurs because of this deductibility changes the picture of how taxes affect different households in Iowa. Taxes paid by the two lowest quintiles do not change, as many earners in these brackets either do not earn enough to owe any federal income tax or do not itemize. Taxpayers in the middle quintile see their effective tax rate decrease by about four-tenths of a percentage point, to 10.3 percent, while the fourth quintile sees a 0.8 percentage-point decrease, resulting in a 9.0 percent effective tax rate.

The greatest effect of the federal offset is witnessed in the top 20 percent of non-elderly taxpayers. Effective tax rates decrease from 9.7 percent to 8.4 percent for the next 15 percent of earners (those making \$78,000 to \$127,000); from 8.4 percent to 7.6 percent for those earning \$127,000 to \$320,000; and from 7.7 percent to 6.3 percent for the top 1 percent of all earners (those making over \$320,000). Thus, earners in the lowest quintile, on average, pay a 10.5 percent effective tax rate and the top 1 percent pay a 6.3 percent effective rate.

Policy Implications

A number of policies contribute to the tax picture outlined above. The income tax, the only progressive tax discussed above, has eroded in various ways during the last two decades. For example, lawmakers implemented increased exemptions on retirement income in 1996 and 1999 and cut all individual income-tax rates by 10 percent in 1998.³ These changes have decreased receipts from the income tax and adversely affected the progressivity of the state tax system.

Sales and excise tax rates, the most regressive taxes, have increased steadily in recent history. The increase in cigarette taxes from \$0.36 per pack to \$1.36 in 2007, along with increases in other tobacco products taxes, added to the regressivity of this tax. Local-option sales taxes (LOST) have become increasingly common in the last 20 years. In 1988, only 3.9 percent of jurisdictions had LOST. This number increased dramatically to 48.1 percent in 1998 and to an overwhelming 88.7 percent of jurisdictions in 2008. Over the same period, the school infrastructure local-option sales tax spread and became universal, and in 2008 was converted into a permanent statewide sales tax. The state rate was raised from 4 percent to 5 percent in 1992. The result is that Iowa’s average state and local sales tax rate rose from about 4 percent in 1990 to nearly 7 percent in 2008.⁴ Reductions in property taxes have been financed in large part by this increase in the sales tax. This results in cutting a roughly proportional tax in order to raise funds with a steeply regressive tax.

The chart and table in this report considers only non-elderly taxpayers and therefore does not include the effects of recently enacted elderly tax reductions, including provisions not yet fully phased in. This legislation does two important things:

- First, it significantly raises the threshold at which no tax is due for seniors, from \$13,500 for married couples and \$9,000 for single persons in 2006 to \$32,000 for married couples and \$24,000 for single persons in 2009. This provision benefits primarily middle-income seniors.
- Second, it gradually phases out the tax on Social Security benefits over an eight-year period (beginning in 2006) so that by 2014, all Social Security income will be tax-exempt, regardless of the income of the beneficiary.⁵

Because the major cost and effect of this legislation is to extend the exemption of Social Security income to earners at higher income levels, it will decrease the progressivity of the income tax and add to the overall regressivity of Iowa’s tax system.

Few policy changes in recent history have improved the fairness of Iowa's tax code. The phaseout of residential utilities that began in 2001 benefited lower-income earners for whom utilities constitute a larger share of income. In 2007, the Legislature expanded the Earned Income Tax Credit (EITC) and made it refundable, offsetting the regressivity of the total tax structure for low-income families.

Policy Options

Several policy changes would make the tax code more fair:

- Further expanding the Earned Income Tax Credit (EITC) would partially offset the regressivity of Iowa's overall tax structure;
- Allowing municipalities to pass local income taxes as a progressive alternative to the local-option sales tax; and
- Avoiding additional increases in sales taxes.

Taken together, Iowa's existing tax structure puts a greater responsibility to pay for public services on low-income Iowans, an entrenched fairness problem that is compounded by the federal deduction offset.

¹ Excise taxes include the cigarette and tobacco tax, the motor vehicle fuel tax and the alcoholic beverages tax.

² A taxpayer who itemizes can elect to deduct either income or sales taxes on his or her federal return. Most Iowa itemizers will benefit more from deducting income than sales taxes, so the ITEP calculations assume that sales taxes are not deducted.

³ *Iowa Tax Rate History*, Iowa Department of Revenue website, available at <http://www.iowa.gov/tax/taxlaw/TaxHistory.html>.

⁴ See IFP Backgrounder, *Putting Fairness First: Questions for Financing State and Local Government in Iowa*, March 2008.

⁵ See IFP Backgrounder, *How Iowa Seniors Will Be Taxed: Changes Coming with 2006 Legislation*, June 2006.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available at <http://www.iowafiscal.org>.

The Iowa Fiscal Partnership is part of the State Fiscal Analysis Initiative, a network of state-level organizations and the Center on Budget and Policy Priorities to promote sound fiscal policy analysis. IFP work is supported by the Stoneman Family Foundation and the Annie E. Casey Foundation.