

## Iowa Income Tax Reform: An Emphasis Upon Sound Tax Principles

Majority Democrats in the Iowa General Assembly have developed a proposal to make significant changes in the structure of Iowa's income tax. This proposal would not raise additional revenue, but it would change various aspects of the tax, including rates, exemptions and deductions. This analysis evaluates these changes on the basis of recognized tax principles: fairness, competitiveness, public benefit and economic efficiency, revenue adequacy, stability and predictability, simplicity, and accountability.

### ***The Basics***

According to the Legislative Services Agency, the income tax reform plan proposed by legislators would reduce average taxes for Iowans earning below \$125,000 — but would be revenue neutral for the state because it would increase taxes for those earning above that level. The proposal contains three basic provisions that cause these changes for different groups of taxpayers: the reduction in income tax rates, the elimination of federal deductibility, and the expansion of several different credits targeted to low- and middle-income earners.

First, the plan would eliminate a part of the Iowa tax code called “federal deductibility” that allows Iowans to deduct the amount they pay in federal taxes from their income when they file a state income tax return. For a tax filer with an income of \$70,000 who paid \$6,000 in federal income taxes, Iowa taxable income would be reduced by \$6,000, to \$64,000. Federal deductibility overwhelmingly benefits higher income taxpayers, since most low-income taxpayers don't pay any federal taxes. A 2003 analysis of Iowa's income tax system found that 80 percent of the benefits from federal deductibility went to the wealthiest 20 percent of Iowa taxpayers.<sup>1</sup>

Second, the income tax proposal would decrease rates for all taxpayers and increase various credits targeted at low- and middle-

### **Key Elements of the Democratic Proposal to Reform Iowa's Personal Income Tax**

- Eliminates federal deductibility, a provision that allows Iowans to deduct federal taxes paid from their income on their Iowa state tax return
- Lowers income tax rates, with a new top rate of 6.98 percent rather than the current rate of 8.98 percent
- Increases the earned income tax credit (EITC) from 7 percent of the federal level to 8 percent of the federal level
- Increases the elderly and blind personal credits from \$20 to \$40
- Increases the child and dependent credit for tax filers with incomes below \$45,000 and adds a child care credit, at 30 percent of the federal credit, for tax filers with incomes between \$45,000 and \$50,000

<sup>1</sup> Institute on Taxation and Economic Policy. *Options for Income Tax Simplification in Iowa*. Washington, D.C.: March 2003.

income taxpayers. The *child and dependent care credit* allows eligible taxpayers to receive a credit for a portion of their child care expenses. This proposal would increase the size of the credit and expand it to families earning between \$45,000 and \$50,000 who are currently ineligible for the credit. The *Earned Income Tax Credit* provides low- and middle-income earners with a refundable credit based on their earnings and the size of their family. This proposal would increase the size of Iowa’s credit to 8 percent of the larger federal credit. Finally, the *elderly and blind personal credits* provide Iowans who are either over the age of 65 or blind with a \$20 credit against the amount they owe in state taxes; this proposal would double that amount to \$40. These changes, paired with the third component of the Democratic plan — an overall reduction in income tax rates — have the effect of lowering average taxes for Iowans with incomes below \$125,000.

**Table 1. Income Tax Changes Reduce Taxes for Most Iowans**

Adjusted Gross Income	Number of Households	Avg Chg in Tax Liability
\$0 to \$10,000	212,172	-\$ 3.86
\$10,001 to \$20,000	180,654	-\$ 22.15
\$20,001 to \$30,000	171,352	-\$ 35.57
\$30,001 to \$40,000	149,157	-\$ 35.28
\$40,001 to \$50,000	121,607	-\$ 38.82
\$50,001 to \$60,000	100,430	-\$ 39.87
\$60,001 to \$70,000	83,358	-\$ 51.53
\$70,001 to \$80,000	69,284	-\$ 58.84
\$80,001 to \$90,000	55,345	-\$ 62.66
\$90,001 to \$100,000	42,200	-\$ 58.82
\$100,001 to \$125,000	61,655	-\$ 19.90
\$125,001 to \$150,000	28,051	\$ 45.55
\$150,001 to \$175,000	14,879	\$131.28
\$175,001 to \$200,000	8,873	\$199.06
\$200,001 to \$250,000	10,275	\$261.44
\$250,001 or more	23,974	\$1,377.28

Source: Legislative Services Agency

## **How Does the Plan Stack Up Based Upon Recognized Tax Principles?**

### **Fairness**

Taxes should be based on ability to pay. Tax changes should be designed to produce a fairer overall system to finance essential public services.

This proposal makes Iowa’s income tax system more progressive and, as a result, makes Iowa’s overall tax system (composed of income, sales and property taxes) less regressive. A tax system is considered *progressive* if taxes increase as a share of a taxpayer’s rising income but *regressive* if taxes take up a larger share of the incomes of those who have a lower ability to pay.

Specifically, this proposal provides tax reductions to most working Iowa families. The expansion of the Earned Income Tax Credit (EITC) continues to move the EITC in the direction of providing state recognition of working family needs comparable to the level now supported by the federal tax code.

### **Competitiveness**

*Taxes should contribute to a level playing field for all in the economy.*

Iowa’s top income tax rate of 8.98 percent has long been cited as a detriment to marketing Iowa’s business climate. Lowering the top rate to 6.98 percent no longer places Iowa at the top among states with the highest top rates and also provides for more comparability in income tax with other states.

### **Public Benefit and Economic Efficiency**

*Tax incentives should promote some public purpose. They should not improperly distort private economic decisions.*

The expansion of the EITC, the child care tax credit and the elderly/blind personal credit recognizes the economic costs that families face and that deserve to be accounted for in the tax code.

## **Revenue Adequacy**

*Taxes must produce sufficient revenues to finance essential state and local public services.*

The proposal is revenue neutral, so it does not increase state revenues to fund public services.

## **Stability and Predictability**

*A tax base should be stable and predictable over the economic cycle.*

The proposal no longer ties Iowa revenues to federal tax policy and therefore increases the stability of the state income tax. Changes in federal tax law will not automatically affect Iowa's tax structure.

## **Simplicity and Accountability**

*The tax system should be easy for citizens to understand and to comply with, and easy for government to enforce and audit. Those entrusted with public money should be accountable to those who provide the funds, through taxes or otherwise.*

The elimination of federal deductibility makes tax filing simpler by eliminating the need to report federal taxes and refunds on the tax form. This also means fewer opportunities for misreporting and means greater accountability.

## **Overview**

The proposal is consistent with recognized tax principles, but it represents only a step in that process. Earlier IFP reports have indicated that the following additional actions should be taken, which would enable Iowa to have a much simpler, fairer and more accountable personal income tax system:

- Adopting federal personal exemptions and standard deductions;
- Requiring married couples to file as they do federally, with commensurately broadened income tax brackets for joint filers;
- Eliminating the preferential treatment of capital gains;
- Eliminating the deduction for 529 plans for tax-filers with incomes over \$75,000 for single filers and \$150,000 for married filers; and
- Raising the state EITC to 30 percent of the federal level.

Iowa currently imposes taxes on tens of thousands of Iowa families with incomes between \$20,000 and \$50,000 who owe no federal taxes. The tax reform proposal generally lowers the taxes they are required to pay in Iowa, but it does not eliminate them. Long-term reform of Iowa's income tax should critically review the issues raised above in order to ensure that Iowa taxes on working families do not start until they have sufficient income to meet basic needs.

# Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Child & Family Policy Center and the Iowa Policy Project, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web 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 Annie E. Casey Foundation and the Stoneman Family Foundation.