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POLICY BRIEF

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Governor's tax cut plan sets stage for service cuts

Reforms for fairness and simplicity could be achieved without losing revenue

By Peter S. Fisher

Summary

Iowa's General Assembly opened with promises from legislative leadership and the Governor for tax reform. We noted key opportunities to assure a fairer and sustainable system in a brief report last fall, *"Introduction to 2018: What should be part of tax reform? And what should not?"*[1] These options remain; some are gaining attention — such as the elimination of federal deductibility and the closing of sales tax loopholes — and some are not.

So how does the Governor's tax plan, now under consideration in the Iowa House as House Study Bill 671, stack up? The plan does include desirable reforms: increasing the standard deduction, eliminating federal deductibility, and modernizing the sales tax by extending it to e-commerce. But those reforms need not have come at the expense of essential public services that inevitably will have to be cut in the face of revenue losses. At the same time, the proposal omits real reforms to enhance fairness in the individual income tax system by recognizing the cost of raising children.

The Reynolds proposal also fails to rein in tax credits or plug tax loopholes, which could have enhanced revenue to offset other changes. Instead, it creates a new loophole: the Qualified Business Income Deduction. And while the plan overall does not increase the regressive nature of Iowa's income tax system, it provides far greater benefits to the wealthy than to moderate- or low-income Iowans.

A central focus of tax reform, especially given current circumstances, should be revenue adequacy. Already, the current system does not produce enough revenue to meet the needs specified by the current Legislature and administration in the budget they approved a year ago. On top of this structural deficit, the Governor's plan would produce annual reductions to the state General Fund of $132 to $299 million, depending on which baseline (without or with federal tax changes) is used. This would only further reduce Iowa's ability to maintain quality public education and affordable community colleges and universities, or to begin to address our water quality problems in a serious way, or to shore up a woefully inadequate mental health system.

Analysis of the Reynolds Plan

As we have argued many times in the past, tax policies should be evaluated against widely accepted principles, the key ones in the current debate being fairness, revenue adequacy, competitiveness and simplicity. We consider each in turn.

Fairness

The overall state-local tax system in Iowa — consisting of roughly equal parts of income taxes, sales taxes, and property taxes — is regressive. The bottom 80 percent of taxpayers in the state pay around 10 percent of their income in state and local taxes, while the top 1 percent pays only about 6 percent.[2]

Iowa's state and local tax system is regressive — the less income in a household, the more heavily that family is taxed as a share of its income.

Iowa's individual income tax is the only revenue source that is progressive and therefore could play a key role in making Iowa's overall tax system fairer, better based upon ability to pay. Sales and property taxes remain regressive, and make the overall system regressive. As the largest source of General Fund revenue, maintaining a robust income tax is clearly essential for revenue adequacy, as well as fairness.

Six major components of the Reynolds plan affect the individual income tax: (1) reduced tax rates for all tax brackets, (2) an increase in the standard deduction, (3) elimination of the deduction for federal income taxes, (4) elimination of the alternative minimum tax, (5) a deduction for "pass-through" businesses equal to 25 percent of the new federal qualified business income deduction and (6) conformity with federal increases in the Earned Income Tax Credit for tax year 2018 and beyond. The plan also calls for expanding the sales tax base by closing a number of loopholes that are largely the result of the rise of the digital and sharing economies; internet sales, ride sharing and residence sharing services, and digital goods no longer would escape the sales tax.

Some components of the plan are progressive, some regressive. Rates are cut in all brackets, but the rates fall about 16 percent for the bottom three brackets, 20 to 23 percent for the top brackets, when fully phased in. However, the ability to deduct federal income taxes on the Iowa return is far more valuable to those at high incomes, so its elimination has a much larger impact on those high-income tax filers, increasing their Iowa taxes substantially. Eliminating the alternative minimum tax benefits higher income groups primarily, as does the qualified business income deduction.

The increase in the standard deduction primarily benefits lower- and middle-income taxpayers who are not homeowners. They do not generally itemize deductions because they do not pay property taxes or mortgage interest, the large deductions that make itemizing worthwhile. Iowa's standard deductions were much lower than federal standard deductions even before the federal tax change but are now even farther behind. Standard (and itemized) deductions are recognized as needed for reasons of tax fairness as well as simplicity, as they leave essential, minimum living expenses (e.g. food, clothing, shelter, and transportation) free of tax.

The federal Earned Income Tax Credit (EITC) was expanded in 2015, but Iowa did not adopt those changes for the state EITC. The Reynolds bill would do so starting in the current tax year (2018). These changes reduce the marriage penalty for EITC recipients and increase the benefits for families with more than two children. For a married couple with three children, these changes are worth $179 per year in Iowa EITC benefits.[3] These are welcome improvements to a key tool for improving the well-being of low-wage working families and individuals, a program that has long garnered strong bipartisan support.

The closing of major sales tax loopholes brought about by shifts in the economy puts brick-and-mortar Main Street businesses on more equal footing with internet giants such as Amazon. The current situation is certainly unfair to local Iowa businesses, who have always been dutifully collecting sales tax. On the other hand, it represents an increase in the sales tax, which adds slightly to tax regressivity, though the dollar amounts are small (see table below).

Table 1. Sales Tax Expansion — Dollars Small, but Greater Share of Income Paid by Lowest Income Taxpayers
Impact of Sales Tax Expansion in Reynolds Tax Bill, by Income Group

Share of Iowa Taxpayers	Income range	Average Income	Average Tax Increase	Percent of Total Tax Change
Bottom 20%	Under $25,000	$ 14,000	$ 16	7%
Second 20%	$25,000 to $43,000	$ 35,000	$ 37	15%
Middle 20%	$43,000 to $65,0000	$ 53,000	$ 47	19%
Fourth 20%	$65,000 to $105,000	$ 82,000	$ 60	25%
Next 15%	$105,000 to $191,000	$ 134,000	$ 75	23%
Next 4%	$191,000 to $426,000	$ 265,000	$ 89	7%
Top 1%	$426,000 or more	$ 1,065,000	$ 224	5%

Source: Institute on Taxation and Economic Policy, analysis of the Reynolds tax plan, February 26, 2018

The net effect of the first round of income tax changes, which would take effect in Tax Year 2019, is shown below in Table 2, which compares the taxes paid under the Reynolds plan with the taxes paid under current Iowa and federal law, including the federal tax bill enacted in December. The Reynolds plan includes revenue targets to "trigger" rate reductions. While the Governor portrays these as a "safeguard" if there is an economic downturn, the triggers are more accurately described as a way to force revenues down — ironically, when times are better, and revenues would naturally rise. In addition, the first set of tax cuts would come in 2019, regardless of revenue growth (no triggers are needed), and those first cuts are a little over half the eventual amount when the tax triggers have taken effect.

Those with income of $100,000 or more represent 19 percent of Iowa tax filers, but would gain 42 percent of the tax cuts. However, the percentage reduction in taxes for that group is 3.8 percent, compared to 6.7 percent for those with income under $100,000.

Overall, the plan would cut taxes for 63 percent of Iowans but raise taxes for 18 percent, while 19 percent would see no change. For the 70 percent of taxpayers with incomes between $20,000 and $500,000 nearly three-fourths — 74 percent — see a cut, while 24 percent would see an increase in taxes. For those with income above $500,000, 62 percent see a cut, 37 percent an increase.

Table 2. Income-Tax Cuts on Average at All Incomes — but Largest Share of Tax Cut at Higher Incomes
*Impact of the Income Tax Provisions of the Reynolds Tax Plan (HSB671) on Iowa Residents, Tax Year 2019**

	Number of	Average Change in Taxes		Percent of Total	Percent with	Percent with
Adjusted Gross Income	Returns	Dollars	Percentage	Tax Reduction	Decrease	Increase
Under $10,000	243,256	$ (7)	-18.4%	0.8%	13%	0%
$10,001 to $30,000	354,309	$ (72)	-28.9%	11.7%	74%	9%
$30,001 to $60,000	370,811	$ (98)	-6.7%	16.7%	76%	23%
60,001 to 100,000	243,438	$ (120)	-3.8%	13.5%	70%	30%
$100,001 to $250,0000	206,282	$ (124)	-1.9%	11.8%	71%	28%
$250,001 to $1,000,000	30,290	$ (2,072)	-8.9%	28.8%	78%	21%
$1,000,001 or more	2,611	$ (1,120)	-0.9%	1.3%	48%	50%
Resident Total	1,450,998	$ (150)	-5.8%	100.0%	63%	18%

**Category I rate cuts in effect, standard deduction doubled, federal income tax deduction reduced to 25%, and Section 179 expensing cap raised.*

Source: Iowa Department of Revenue, Memo to Jeff Robinson of March 2, 2018 on HSB 671, Tables 5A and 6A

The impact of the bill for Tax Year 2023 is shown below. At that point, all the further rate reductions and other changes that were contingent on the state achieving revenue targets are assumed to have occurred. Those with income of $100,000 or more would gain 56 percent of the tax cuts. However, the percentage reduction in taxes for that group is 8.2 percent, compared to 13.1 percent for those with income under $100,000.

Overall, the plan by 2023 would cut taxes for 68 percent of Iowans but raise taxes for 13 percent, while 19 percent would see no change. Among taxpayers with incomes between $20,000 and $500,000, 80 percent see a cut, while 18 percent would see an increase in taxes. For those with higher incomes, 69 percent would see a cut, 30 percent an increase.

Table 3. For Resident Taxpayers, Over Half of Benefit to $100,000-Plus Earners

Impact of the Income Tax Provisions of the Reynolds Tax Plan (HSB671) on Iowa Residents, Tax Year 2023

	Number of	Average Change in Taxes		Percent of Total	Percent with	Percent with
Adjusted Gross Income	Returns	Dollars	Percentage	Tax Reduction	Decrease	Increase
Under $10,000	232,600	$ (7)	-17.6%	0.4%	12%	0%
$10,001 to $30,000	338,097	$ (104)	-48.3%	8.5%	76%	7%
$30,001 to $60,000	378,704	$ (193)	-13.7%	17.7%	82%	16%
60,001 to 100,000	258,438	$ (277)	-9.1%	17.3%	77%	22%
$100,001 to $250,0000	248,619	$ (495)	-7.7%	29.7%	78%	21%
$250,001 to $1,000,000	37,157	$ (2,365)	-10.5%	21.2%	80%	19%
$1,000,001 or more	3,129	$ (7,080)	-5.6%	5.3%	56%	42%
Resident Total	1,496,744	$ (277)	-9.8%	100.0%	68%	13%

Source: Iowa Department of Revenue, Memo to Jeff Robinson of March 2, 2018 on HSB671, Tables 9A and 10A

Another aspect of fairness is the equal treatment of equals. Taxpayers who have similar income or are similarly situated should pay about the same in taxes. In particular, this means that taxes should vary only with total actual income, not according to the source of that income, since a dollar from one source represents the same ability to pay as a dollar from any other source.

The qualified business income deduction violates that principle because it affords special treatment to certain business income. While those earning wages and salaries have to record all of it on their income tax return, those with income from a partnership or other kinds of "pass-through entities" get to deduct a percent of that income off the top.[4] This loophole is also an open invitation to game the system; tax lawyers are already busy figuring out ways to convert business salaries into pass-through profits to get the special deduction.

Moreover, while the Governor's proposal provides a great deal in tax cuts, it does not address one of the biggest inequities in Iowa's tax code — the lack of recognition of the cost of caring for dependents. The recent federal tax cut legislation recognized this by doubling the federal child tax credit to $2,000, but Iowa's child tax credit remains at only $40. To be consistent with federal tax treatment and to better reflect the cost of raising children, Iowa's credit should be much higher.

Revenue Adequacy

Iowa has had a revenue problem for the past several years, with continual budget cuts, including mid-year cuts in the current and previous fiscal years. The source of this self-evident revenue problem can be found partly in the 2013 commercial property tax cut, which currently drains about $300 million from the General Fund. Another source of the problem is the growth of business tax credits, which cost the General Fund $200 million in 2011 but have grown by half, to $300 million, in the current fiscal year, when other areas of the budget have seen little growth.[5]

Also at fault is a new sales tax exemption for "consumables" in manufacturing; it was expected to cost $25 million but may well be taking upwards of $80 million a year from the General Fund.

In the face of a chronic revenue imbalance, it would be irresponsible to propose any tax reform that further erodes General Fund revenue. Yet that is what the Governor's plan does. By 2023, the Reynolds plan will mean $299 million less going into the state General Fund than would be the case without the Reynolds changes. Furthermore, as we have pointed out elsewhere,[6] over half of the income tax cuts occur for tax year 2019, before the first trigger even takes effect, undercutting the argument that the triggers in the bill provide a revenue safeguard.

When evaluating the revenue impact, the Reynolds administration has argued that it is revenue neutral. They come to this conclusion by, first, using a different baseline for the revenue comparison: future revenue as if the federal tax bill had never been passed. In that way, the General Fund reduction by 2023 is $111 million instead of $299 million (the figure when compared to revenue under all current state and federal law).[7] Second, they add local government revenue changes into the equation: School infrastructure and local-option sales taxes will increase. Third, they look at the cumulative five-year effect. When you do all that, you find a state General Fund loss of $135 million, and a local revenue gain of $141 million, for the five years 2019 through 2023.[8]

Here's the rub: by 2023, the annual state General Fund loss will be $111 million, even by the Governor's calculation, and the annual local revenue gain just $31-$33 million, and that will be the approximate situation from then on. In other words, the bill by then is a net revenue loser for state and local governments combined. And the General Fund is a loser no matter how you look at it, from at least fiscal year 2021 on into the future.

Iowans collectively will save about $2.5 billion per year from the federal tax cuts themselves.[9] If Iowa did not change its tax laws, state income taxes for Iowa residents would go up about $148 million in tax year 2019 because of the lower deduction for federal taxes on Iowa tax returns.[10] Iowans would still save $2.35 billion, 94 percent of the federal tax cut. Given Iowa's chronic revenue problems, that $148 million would be a welcome plug in the dike that would allow some restoration of services that have been cut time and again over the past several years. Instead the Reynolds plan is to cut income taxes not just by that $148 million, but by another $108 million beyond in fiscal 2020, and by a total of $404 million by 2023.[11]

Even without the federal deductibility change, Iowans would still save $2.35 billion, 94 percent of the federal tax cut. That would save $148 million for education and other state-funded services in FY19.

Competitiveness

The competitiveness principle ought to mean simply this: A state's overall tax system should not be significantly out of line when compared to other states. Here's the thing: Iowa's tax system gets a good grade on this measure. Overall taxes as a percent of personal income, the standard measure of comparison, have averaged 10.4 percent in Iowa and 10.4 percent in the U.S. over the most recent three years available: 2013-15.[12] We are not out of line; in fact, we are right in the middle.

Furthermore, the same picture results when you look just at the taxes falling on business. Two different assessments by accounting firms of overall state and local taxes on business have come to the same conclusion: Total business taxes in Iowa are about average. The Anderson Economic Group most recently found Iowa to be 28th among the 50 states, while Ernst and Young ranked Iowa 29th.

In short, there is no case for cutting Iowa taxes on competitiveness grounds. Still, while federal deductibility makes Iowa's top income tax rate (8.98 percent) look much higher than it really is, that top rate has been cited as a competitive barrier when businesses and individuals make decisions about where to locate and live. In fact, almost no one in Iowa pays that top rate, because Iowa is one of only three states that allow taxpayers to fully deduct federal income taxes on their state income tax returns (three other states allow a partial deduction). If Iowa removed this federal deductibility provision, the top rate could be lowered below 7 percent without any loss to the state (the Governor's proposal lowers that rate to 6.9 percent), provided there are not other provisions adopted to reduce revenue.

Simplicity

Tax simplification has been an argument used for Iowa tax reform and has been used to promote both the Senate's and Governor's plans. One important point often missed in such discussions is that simplicity comes not necessarily with, or just because of, a reduction of the number of tax rates that apply to taxable income. Rather, it comes with simplifying the method of determining taxable income. In both cases, there are improvements in simplicity aside from other merits of, or disadvantages to, the proposals. The Governor's plan makes the Earned Income Tax Credit simpler because recipients would be able to simply take 15 percent of the federal EITC without adjusting for differences in Iowa and federal law. In addition, the increased standard deduction would make figuring taxes more simple for many who currently itemize deductions. So the proposal does offer more simplicity than under current law. Finally, the elimination of federal deductibility reduces the amount of information that needs to be reported and the calculations that need to be made.

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[1] Iowa Fiscal Partnership, "Intro to 2018: Sensible improvements for Iowa tax policy." October 2017. http://www.iowafiscal.org/sensible-improvements-for-iowa-taxes/

[2] Institute on Taxation and Economic Policy, Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 5th Edition, 2015. https://itep.org/whopays/iowa/

[3] Chuck Marr, "Tax Deal Makes Permanent Key Improvements to Working-Family Tax Credits." December 16, 2015, Center on Budget and Policy Priorities, https://www.cbpp.org/research/federal-tax/tax-deal-makes-permanent-key-improvements-to-working-family-tax-credits#_ftn5 The impact of the provisions on the federal EITC for a married couple with three children in Marr's piece was multiplied by 15 percent, because Iowa's EITC is 15 percent of the federal.

[4] A pass-through entity is a business established as a proprietorship, a partnership, an LLC, or a subchapter S corporation, where income is not taxed at the business level but instead is passed through to the partners or owners, who then pay personal income tax on that income. While often touted as a break for "small business," this exemption applies to many high-income individuals who benefit from real estate investment or hedge fund investment partnerships.

[5] Iowa Policy Project analysis of the Department of Revenue's "Contingent Liability Reports" from December 2017 and earlier years.

[6] Peter Fisher, Iowa Policy Points blog, Feb. 21, 2018. "Triggers to drive Iowa down." https://iowapolicypoints.org/2018/02/21/triggers-to-drive-iowa-down/

[7] When compared to the REC forecast before federal reform, the Reynolds plan produces a 246.3 million reduction in income tax revenue partly offset by $114.6 million in new sales tax revenue. In addition, corporate income taxes rise by 20.6 million because of the reduced deduction for federal income taxes, helping to pay for part of the Reynolds income tax cuts.

[8] Iowa Department of Revenue, Tax Research and Program Analysis Section, memo to the Legislative Service Bureau, Feb. 19, 2018.

[9] Institute on Taxation and Economic Policy, analysis of the Reynolds tax plan, February 26, 2018

[10] Iowa Department of Revenue, Tax Research and Program Analysis Section, spreadsheet "Federal Tax Act Analysis by income class 2-9-18.xlsx"

[11] See Table 12, Iowa Department of Revenue, Tax research and Program Analysis Section, memo to the Legislative Service Bureau, Feb. 19, 2018.

[12] U.S. Census Bureau, State and Local Government Finances, https://www.census.gov/govs/local/ We average over three years because annual fluctuations can be substantial. For the most recent three years, the percent of income going to taxes in Iowa was slightly below the national average one year, equal to it another, and slightly above in the third.