Rethinking Iowa’s Personal Income Tax
Tax Reform Based Upon Recognized Tax Principles

By Charles Bruner

Iowa’s personal income tax system has been subject to a variety of criticisms over the years. While the only source of state revenue that is moderately progressive and therefore capable of keeping Iowa’s overall tax structure from more heavily taxing those with the least ability to pay, it also has been seen as overly complicated from a tax preparation standpoint. Its top marginal rate of 8.98 percent has been cited as a barrier to marketing Iowa as a place for to locate business. Still, Iowa’s personal income tax is a revenue source that grows with the growth in the economy. It represents a very important revenue source for the state, providing approximately 50.9 percent of the state’s general fund tax receipts, and 31.5 percent of the combined state general fund and property receipts in SFY 2002.

In 2003, the Governor and the General Assembly initially agreed to examine Iowa’s income tax system on the basis of recognized tax principles. Early on, however, this joint work ceased, and the majority party in the General Assembly crafted its own version of income tax reform, without agreement from the Governor or the minority party in the General Assembly. On party-line voting, the General Assembly passed changes to Iowa’s income tax system within a bill establishing the Governor’s top priority, the Iowa Values Fund. The Governor item-vetoed the income tax changes, and his vetoes were challenged by legislative leadership. The Iowa Supreme Court ruled on June 16, 2004, that the vetoes were unconstitutional, and nullified the entire bill.

Principles for Evaluating Iowa Taxes and Tax Proposals

1. Fairness
Taxes should be based on the ability to pay; those with similar ability to pay should have similar tax burdens. In general, tax fairness should be at the heart of tax deliberations and efforts should first be made to ensure that tax changes produce a fairer overall system.

2. Competitiveness
Taxes should not impose a burden for business or labor that places the taxing jurisdiction at a significant disadvantage for attracting or retaining business or employment.

3. Public Benefit and Economic Efficiency
Tax incentives should promote some public purpose. Incentives that serve no public purpose can distort private economic decisions, making the Iowa economy less efficient.

4. Revenue Adequacy
Taxes must be capable of producing sufficient revenues to finance state and local public services.

5. Stability and Predictability
Other things equal, a tax base that is more stable and predictable over the business cycle is preferred.

6. Simplicity
The tax system should be easy for citizens to understand and taxpayers to comply with, and it should be easy for the government to collect the tax and audit compliance.

7. Accountability
Those who spend money should be accountable to those who provide the funds, through taxes or otherwise.
The changes passed by the 2003 Legislature would have reduced overall income tax rates, lowering the top marginal rate from 8.98 percent to 7.85 percent. When fully phased in, the lower rates would produce a tax reduction of over $300 million annually. An earlier report from the Iowa Policy Project and Child and Family Policy Center provided a full analysis of that controversial tax legislation, basing the analysis upon recognized tax principles (see box for description of those principles). That analysis showed that the Legislature’s tax bill did not adhere to these tax principles and, in particular:

- Did not address issues of simplification (one of the stated purposes of the reform);
- Made Iowa’s overall tax system more unfair;
- Failed to achieve the goal of lowering the top tax rate to a level competitive with neighborhood states; and
- Seriously eroded the revenue adequacy and balance of Iowa’s tax system.¹

When coupled with a freeze in the phase-out of the sales tax on residential utilities (also in the legislation and also vetoed by the Governor), the analysis showed that the bottom 20 percent of all Iowa taxpayers actually would pay more in state taxes under the legislation, while the wealthiest 1 percent of Iowans would see an average tax cut of $3,580. Iowa’s overall tax system would become substantially more regressive and less capable of meeting public needs.

This past winter, the Iowa Policy Project and the Child and Family Policy Center worked to develop an Iowa personal income tax reform proposal that would address the criticisms that have been leveled at the current system and adhere to recognized tax principles. This report provides a description of that tax reform.

**Components for Reforming Iowa’s Personal Income Tax**

Based upon recognized tax principles, Iowa’s personal income tax system has significant flaws. In particular, it is complicated rather than simple for taxpayers to complete. It suffers from a lack of fairness, both in terms of vertical and horizontal equity. It gives the appearance of having higher tax rates than it actually does, which has been cited as an impediment to economic development. Each of these is discussed below:

**Simplicity**

Many proponents of income tax reform have advocated a “postcard” state income tax, where filers need only fill in their taxable income from the federal income tax return and then use a tax rate table to determine how much they owe in state taxes. Iowa’s system, however, requires substantial additional calculations. A few of these, which apply to individuals with certain types of income, are unavoidable. The federal government does not allow states to tax interest on United States treasury bills or bonds, although they are taxed at the federal level. Therefore, people with interest from treasury bills or bonds have to subtract that amount from state taxable income, even if Iowa were to conform to other federal calculations and definitions. The federal government also allows individuals to deduct the state income taxes they pay from overall federal tax liability. This deduction needs to be eliminated in determining state taxable income. There are several more such items that would need to be added back in or subtracted from federal taxable income because of federal requirements, which means that the state income tax cannot be based solely on federal taxable income for all taxpayers. Still, the substantial number of Iowans who do not have these types of income or special deductions could use a postcard-type form for an Iowa return, if Iowa adhered to other federal calculations of taxable income. The forms could be made substantially simpler for all filers, as well.
What makes Iowa’s system complicated, however, are several provisions of state law that differ significantly from the federal calculations of taxable income. Three of these apply to a very large proportion of Iowa tax filers:

- Federal deductibility
- Standard deductions and personal exemptions
- Married couples treated as single filers.

**Federal deductibility.** Iowa allows taxpayers to deduct the federal income taxes they pay from their state taxable income. Since this federal deductibility is calculated on a calendar year payment basis (as opposed to a tax year accrual basis), it requires adding in any taxes paid during the calendar year (including withholding and estimated payments) and adding or subtracting any adjustments made from prior year federal claims (refunds received or additional payments provided for the prior tax year). This complicates state filing by adding at least two lines to the state income tax form and requiring review not only of current year tax records but prior year tax records, as well. Married separate filers must apportion the prior year’s refund based on their prior year’s Iowa net income.

**Standard deductions and personal exemptions.** The federal government provides higher standard deductions than does Iowa, so much so that many taxpayers who claim a standard deduction at the federal level must itemize at the state level to get the full benefit of the deductions that are allowed. This constitutes an additional tax preparation effort. Even if taxpayers claim the standard deduction on both state and federal returns, the different standard deduction sizes means that taxable incomes at the state and federal level are different. As a result, some additional calculations are required at the state level to get to taxable income.

If the state were to adopt federal standard deductions, it would greatly simplify tax filing for Iowans who do not use itemized deductions at the federal level. It would also reduce tax preparation costs for Iowans.

The same holds for personal exemptions. The federal income tax provides a personal exemption of nearly $3,000 per person (spouses and dependents), while the state provides a credit of $40 per person. This requires substantially different calculations and a more complicated Iowa tax form. The personal exemption or credit is the method used to recognize the basic costs of living for household members, which tax experts generally agree should not be subject to personal income tax. Iowa’s credit is much less in value than the federal government’s exemption. Another consequence of the lower standard deductions and personal exemptions is that many low-income Iowa families who do not have enough income to have a tax liability at the federal level, do have a tax liability at the state level. These families have to file for state taxes, even though they do not have to file for federal taxes. Adopting the federal exemptions instead of the state credit would result in a state tax system that could more easily use federal taxable income as the tax base. It also would result in a state tax system that no longer taxes individuals, particularly families with children that the federal system considers too poor to tax.

**Married couples treated as single filers.** The federal government requires married taxpayers to file joint returns, with some broadening of the tax brackets for married filers. Iowa allows married couples the option to file as single individuals, but offers no broadening of the tax brackets for married filers. The result is that married couples with two incomes almost always are much better off filing as single filers, but this greatly complicates their tax preparation. While all income is combined on the federal form, it must be separated on the state form. Further, many of the allowed deductions from income must be apportioned to one spouse or the other, often using apportionment formulas based upon relative net income for the current or prior tax years. The result is that a significant number of families who can file their
federal tax returns themselves require assistance in filing their state returns, adding to their costs. The single greatest complicating feature of Iowa’s income tax system is the provision that treats most married couples as separate individuals.

**Fairness**

There are two different issues related to tax fairness, or equity. The first is vertical tax fairness, or whether the tax system taxes people with different incomes and wealth fairly. The second is horizontal tax fairness, or whether the tax system taxes people with equivalent incomes and wealth fairly. Clearly, what is fair is to some extent a subjective judgment, but it is generally recognized that taxes should be based, to some extent, on people’s ability to pay.

The personal income tax is the only major Iowa tax that is based upon income. The sales tax is based upon purchases, including the purchase of many essential goods. Although Iowa does not tax food or prescription drugs, the sales tax takes a larger share of lower-income people’s income than of higher-income people’s income, and therefore is a regressive tax. The property tax is imposed upon property and directly affects homeowners, but also is passed, at least partly, onto renters in the form of higher rent. It also has been shown to be regressive in its impact, taking a larger share of lower-income people’s income than higher-income people’s income.

In Iowa, the personal income tax is slightly progressive, taking a somewhat larger share of higher-income people’s income than lower-income people’s income, although not nearly so progressive as the federal income tax. The slight progressivity of the personal income tax, however, does not offset the regressivity of Iowa’s other taxes. The result is that Iowa’s overall tax system taxes lower-income people at a higher rate than it taxes higher-income people.

Iowa’s income tax system could be made more progressive by better conforming with the federal income tax system. From the point of view of vertical tax fairness, this would make Iowa’s tax system fairer. There also is strong evidence that this view is shared by Iowans. This February, IPP and CFPC commissioned an Iowa Voter Survey to determine Iowa voters’ views on the state tax system. This poll, conducted by Selzer and Company (which does the Iowa Poll for The Des Moines Register), showed that Iowa voters strongly believe that the wealthiest Iowans (making over $200,000 per year) do not pay their fair share of taxes, while poor working Iowans (making $20,000 per year or less) pay more than their fair share. These beliefs are held by both higher income and lower income voters and Republican, Democratic and independent voters.

Clearly, there is public sentiment, as well as tax principles, for making Iowa’s income tax system more progressive, rather than less progressive (as the proposal passed by the General Assembly would do).

Iowa’s current tax system also has some horizontal tax inequities. As mentioned earlier, Iowa provides a tax credit of $40 for each individual in the household. This $40 credit, which is intended to provide tax recognition for the cost of providing for dependents, is the smallest among all states with an income tax. The combination of federal deductibility, a large $3,000 personal exemption on federal income tax returns, and a small $40 credit on the state income tax return creates an unintended tax advantage for families with no children over families with children. For childless families, the value of deducting their federal taxes on their state income tax return is usually worth more than the $40 child tax credits that the family with children receives. As a result, a family with children usually pays more in state income taxes than a family with the same income but no children. Rather than recognizing the cost of raising children,
Iowa’s personal income tax system actually taxes families with children more than families with the equivalent income but without children. In effect, Iowa’s personal income tax has a “child raising tax penalty.” This represents a major instance of horizontal tax inequity.

**Competitiveness**

Iowa is one of only three states in the nation that allow 100 percent of federal taxes to be deducted on the state income tax return. Because of this deductibility, Iowa’s top income tax rate of 8.98 percent is not the true, effective tax rate taxpayers pay. In fact, due to deductibility, the top tax rate in Iowa is closer to 5.83 percent. Still, business groups often have argued that Iowa’s top income tax rate of 8.98 percent gives the appearance that Iowa is a high-tax state and makes it more difficult to attract business.

Lowering the top rate has been promoted as one way to make Iowa more economically competitive. As the map below shows, Iowa’s top tax rate is substantially higher than neighboring states with income taxes.

Eliminating federal deductibility, coupled with some lowering of the rates, is one way to lower the top tax rate and ensure that Iowa’s actual tax rates are fairly represented in comparisons with other states.

**Addressing the Flaws in Iowa’s Personal Income Tax System**

Fortunately, there are ways to simplify Iowa’s tax system, make it fairer from both a vertical and horizontal equity perspective, and lower the top tax rate to make it more comparable and competitive with other states’ top marginal rates. These involve the following:

- Eliminating federal deductibility
- Adopting federal standard deductions and personal exemptions
- Requiring married couples to file jointly while broadening the tax brackets for married filers to address the issues of any potential “marriage tax penalty”
- Changing the rate structure and lowering the top tax rate.

A “revenue neutral” approach from a state tax collection perspective that incorporates all of these provisions is shown in Table 1 (Page 6), with its impact upon resident tax filers of different incomes. This approach involves three income tax rates, starting at different levels depending upon tax filing status:
As is shown, the tax brackets are 75 percent wider for married couples who file jointly and 25 percent wider for single heads of households and qualifying widows or widowers. These result in lower effective tax rates for married couples than for single individuals with the same income.

As Table 1 shows, the overall state revenue obtained from the alternative approach is almost identical to the current system, a difference of only $143,322 out of more than $1.67 billion. There are, however, substantial shifts in who pays the tax. Taxpayers with incomes under $70,000 receive overall reductions in their taxes, while taxpayers earning over $70,000 receive increases. When further broken out by different filing statuses, married couples filing jointly experience benefits up to the $80,000 taxpayer bracket. Overall, nearly 80 percent of Iowa taxpayers benefit from these changes in lower taxes. Although revenue neutral from a state tax collection perspective, the alternative benefits most working Iowans and makes Iowa’s tax system simpler and fairer. It also reduces the top income tax rate to 6.9 percent, below Minnesota’s and competitive with most surrounding states.

Clearly, Iowans in the top 1 percent of income in the state pay significantly more in state income taxes under the alternative. The 8,794 Iowa resident taxpayers making over $250,000 per year pay an addi-
tional $38.5 million in state income taxes, and their income tax incidence rises from 4.48 percent to 5.28 percent, a 0.8 percent increase in overall tax liability.

These figures, however, must be considered in the context of tax changes over the last decade. An Institute on Taxation and Economic Policy (ITEP) study of state tax law changes between 1989 and 2002 showed that Iowa’s tax changes have disproportionately benefited the very wealthy. While those with taxable income below $65,000 saw changes in their tax liabilities of less than half of a percent of their overall income, those with incomes over $257,000 saw their taxes reduced by 2.4 percent as a share of their total income. This constituted by far the largest tax cut for the wealthy among all states in the country over this period. The next largest tax cut for the wealthy was 1.5 percent, in North Carolina.4

The result of enacting this alternative state income tax would be to address some, but not all, of the disproportionate impact that tax changes in Iowa have made over the last decade. Figure 2 is an adaptation of ITEP’s analysis of tax law changes between 1989 and 2002 in Iowa, showing first the impact of changes without our proposed income tax alternative and then with incorporation of the alternative.

As Figure 2 shows, even if this proposed income tax reform were adopted, wealthier Iowans would still be ahead in the share of benefits from tax changes in Iowa over the last decade. Iowa’s overall tax system would remain slightly regressive, meaning that lower-income individuals pay a higher proportion of their income than higher-income taxpayers. Iowa’s tax system would be less unfair, but there would still be a substantial way to go to making it truly fair, or even getting back to its position in 1989. (The tax changes proposed here still produce larger percentage reductions in taxes for the top income groups than

\[ \begin{array}{cccccccc}
\text{Avg Income} & \text{Bottom 20%} & \text{Next 20%} & \text{Middle 20%} & \text{Next 20%} & \text{Next 15%} & \text{Next 4%} & \text{Top 1%} \\
\text{Without} & -0.4\% & -0.2\% & 0.2\% & 0.2\% & -1.6\% & -1.2\% & -2.4\% \\
\text{With} & -0.5\% & -0.3\% & -0.2\% & -0.4\% & -1.4\% & -0.8\% & -1.6\% \\
\end{array} \]

Sources: Institute on Taxation and Economic Policy, Iowa Department of Revenue
for lower income groups, compared to the tax system of 1989, which means that the income tax would still be less progressive than in 1989.) Still, by lowering the top rate, it also eliminates one of the arguments leveled against the current system, that it is not competitive with other states.

Finally, while the tax alternative is neutral from a state tax collection perspective, its impact is to reduce the overall tax burden for Iowa resident taxpayers. That is because a significant portion of the increased state taxes paid by those with high adjusted gross incomes are offset by reduced federal tax liability, due to the allowance of state income taxes paid as an itemized deduction for federal income tax purposes. These taxpayers generally are taxed at a marginal federal tax rate of 30 percent or more. On the other hand, those receiving income tax cuts in the alternative plan proposed here are mostly in lower income tax brackets and less likely to itemize their federal returns and receive a deduction for state income taxes paid. In this context, the alternative could be considered an income tax cut; potentially $20 million or more additional money would be kept in the hands of Iowa residents as opposed to the federal government.5

Conclusion

The Iowa Personal Income Tax deserves examination and reform, based upon recognized tax principles. The alternative presented here shows that the Iowa income tax can be improved substantially – from the point of view of fairness, simplicity and competitiveness.

There are other reforms that could be made to the Iowa personal income tax system that would go even further to producing simplicity and fairness. Eliminating Iowa’s special treatment of capital gains represents one approach6, as does eliminating several other special Iowa provisions. These could be used to address issues of revenue adequacy – or to further revise actual income tax rates.

The purpose of presenting this alternative is simply to show that Iowa’s personal income tax system can and should be reformed – and there are basic elements that should go into that reform.

Dr. Charles Bruner is Executive Director of the nonprofit Child and Family Policy Center, established in 1989 to better link research and policy on issues vital to children and families. He has written widely on public policy approaches to more comprehensive, community-based responses to children, family and neighborhood needs.
Recommended resources:

For further information on Iowa tax policy, see the following Iowa Policy Project and Child and Family Policy Center publications, available on the IPP website: www.iowapolicyproject.org.


Endnotes:


3 While many have talked of a “marriage tax penalty” at the federal level, it depends upon the distribution of income in the family to determine if a family benefits or is harmed by the joint filing requirement. For families with only one spouse with income, the current federal system actually provides a benefit for joint filing over two separate filings, as the family can take advantage of larger deductions and exemptions and broadened tax brackets. For such families, the option to file separately on Iowa income tax provides no benefit, while changing to the Federal system — broadening the brackets for married couples filing jointly — would do much more to benefit that family. The federal income tax has different sizes for its tax brackets, and thus different tax tables (the XYZ tables) to reflect different taxes for single, married and head-of-household tax filers. XYZ tables do not make filing more complicated, they simply provide different overall tax obligations for people in different types of households. How much wider the tax brackets are for married couples filing jointly will determine the extent to which married filers face reduced or increased taxes as a result of filing jointly. The more equal the income between spouses, the wider the brackets need to be to derive a benefit from filing jointly.


5 As an example of how this works, consider a hypothetical state with two people. One person has a low income and pays $100, but would pay less – $80 – under the alternative system. The other person has a high income and pays $500, but would pay more – $520 – under the alternative. State revenue is the same – or neutral – at $600. But the wealthier person gets to deduct the $20 increase and saves $6 in federal taxes. The poor person doesn’t itemize and federal taxes remain unchanged. The net burden on the two residents is –$20 and +$14, or a net decrease of $6, even though state revenues remained the same.