IA Tax Reform

new file - IA Tax Reform (IA Tax section)

Time for a Better Deal

Iowa's Unfinished Tax Reform Agenda

Citizens for Tax Justice

Douglas P. Kelly
Policy Analyst

Jonathan M. Crystal
Policy Analyst

Iowa Citizen Action

Jay Larson
Executive Director

Iowa Tax Reform Action Coalition

Harold Butz
President

Bill Smith
Policy Analyst

February 1989

Restoring Fairness to Iowa Taxes

IOWA'S CURRENT TAX SYSTEM IS SERIOUSLY REGRESSIVE. Instead of taxing according to ability to pay, Iowa heaps onerous burdens on low- and middle-income families while asking the richest citizens to contribute a significantly smaller share.

This inequitable tax situation results from a combination of imperfect tax policies and missed opportunities. The passage of the federal Tax Reform Act of 1986 gave Iowa a golden opportunity to improve the fairness of its tax system. By following the federal lead, the state could have made its system more progressive and made the well-off begin to pay their fair share.

But Iowa did not fully conform to the new federal guidelines. State legislators allowed several gaping loopholes to remain in the income tax code. These loopholes prevented badly-needed funds from reaching the treasury and forced lawmakers to seek increased excise taxes to make up the difference. This failure, coupled with regressive sales and residential property taxes, has led to a tax system with the following distributional effects on families of four:

TABLE ONE: THE CURRENT TAX SYSTEM IN IOWA, 1989

Quintile Income	I $10,153	II $23,296	III $34,432	IV $47,710	Top 15% $69,763	Top 5% $193,155	Top 0.7% $631,200
Income Tax/Income	2.1%	3.3%	3.6%	4.0%	4.3%	4.3%	5.5%
Sales & Excise/Income	5.4%	3.8%	3.2%	2.8%	2.4%	1.5%	1.0%
Property Tax/Income	6.6%	3.4%	2.8%	2.6%	2.5%	1.9%	1.5%
TOTALS	**14.1%**	**10.5%**	**9.6%**	**9.4%**	**9.2%**	**7.7%**	**8.0%**

The results are staggeringly unfair. While families in the top five percent of the income scale contribute 7.7 percent of their income to help pay for state and local services, families with twenty times less income are paying a share of 14 percent! In other words, the poorest twenty percent of Iowa families are paying close to twice as high a share of income in Iowa state and local taxes as are the wealthiest families.

It is time to put some fairness back into the Iowa state tax code. Loopholes need to be closed and tax burdens need to be shifted from lower income groups to those people who have the greatest ability to pay—and who currently benefit so greatly from Iowa's regressive tax structure. The following pages analyze Iowa's current income, property, sales and excise taxes and suggest progressive alternative tax programs (with additional options listed in the appendix).

The Iowa state legislature in recent years has enacted groundbreaking legislation in several different areas. It is now time to dedicate an equal amount of discussion, energy and enthusiasm to writing fairness back into the state tax code.

Personal Income Tax

If Iowa is to increase the progressivity of its tax system, it must begin with its income tax. The income tax remains by far the fairest of all major revenue sources. It is the *only* tax that takes according to people's ability to pay—and it can be used to offset the regressivity of sales and property taxes.

A Lost Opportunity

Before the federal Tax Reform Act of 1986, most state income taxes were a mess. Iowa, like most other states, traditionally linked its definition of adjusted gross income to the federal definition. As a result, the very same loopholes that allowed the wealthy to avoid paying their fair share of the federal tax burden also permitted them to sidestep their *state* obligations.

But the federal Tax Reform Act of 1986 had important consequences for the states. Those which had tied their income taxes either explicitly or implicitly to the federal definition of adjusted gross income now simply had to follow the federal lead to close many of the loopholes and tax shelters that had provided rich families with state tax windfalls, eroded the progressivity of state income tax systems, and resulted in a loss of revenue.

Unfortunately, Iowa did not take full advantage of this golden opportunity, and in some respects, even made things worse. By compressing its rate structure, retaining important loopholes in its base, and giving little or no relief to lower-income taxpayers, Iowa lawmakers passed up an opportunity to establish a truly progressive income tax.

Tax Rates

The state compressed its rate schedule from thirteen brackets to nine and lowered its top marginal rate to 9.8% from 13% (see Appendix for the rate schedule). Though the current rate schedule has nine brackets, the appearance of progressivity is greater than the reality because the rates increase very rapidly for low brackets but then rise much less sharply above $15,000 in taxable income.

While the decrease in the lowest rates is a welcome development, the unnecessary reduction of the highest rates has resulted in a windfall for the rich which, combined with the structure of the tax base, contributes to making the income tax not nearly as progressive as it could and should be.

Tax Base

Before 1986, loopholes and tax shelters had seriously distorted the relationship between total family income and adjusted gross income—AGI being the base of income used in calculating tax liability. But the federal Tax Reform Act of 1986 broadened the base by ending many of these tax breaks.

Though Iowa did conform to the new definition of federal Adjusted Gross Income and itemized deductions, two major state income tax loopholes were retained:

- While the capital gains exclusion was eliminated on the federal level, Iowa lawmakers decided to preserve a 60 percent exclusion for the first $17,500 in capital gains income. Whereas working Iowans include *all* of their wages in computing their taxable incomes, only forty percent of the profits from selling stocks, bonds and so forth, up to the $17,500 cap, is considered taxable income. Instead of merely capping the capital gains tax break, Iowa lawmakers should have gone all the way and eliminated the capital gains loophole.
- The second loophole allows everyone (not just itemizers) to deduct from their state tax bill the full amount of federal income taxes paid. Only four other states in the nation allow full deductibility. Why is this loophole so rare? Because it allows hundreds of millions of dollars annually to bypass the state treasury and because it disproportionately benefits the very wealthy.

To be sure, there was some good news. Many of the changes on the federal level were adopted, including tough restrictions placed on tax shelter "losses." But leaving in a capital gains tax break and the deduction for federal income taxes while lowering the top marginal rates undercut much of the good that the state achieved.

In the end, instead of shifting the income tax burden from low- and middle-income families to the richest, the new tax system increases *everyone's* income taxes.

A MORE PROGRESSIVE SOLUTION

Iowa's income tax is not beyond repair. There are ways that Iowa lawmakers can fulfill the promise of tax reform.

The first step should be to eliminate the capital gains exclusion in full. The capital gains break loses revenue, does little if anything to stimulate investment, and disproportionately benefits the wealthy. The exclusion is particularly ineffective as part of Iowa's tax structure, since it is not (and cannot be) restricted to investments that do anything to contribute to Iowa's economic development.

Second, the state should eliminate the deduction for federal taxes paid. This is an extremely expensive loophole that most states do not allow and that makes the income tax much less progressive than it otherwise would be.

These two steps will allow the state to raise money in a fair and progressive manner. The revenue then can be used to provide income, property and/or sales tax relief to low-and middle-income taxpayers.

One approach to income tax relief for average families would be to change the marginal rates. If the tax base is broadened, there will be no need to increase the top marginal tax rate to raise additional revenues. The changes in the rate schedule suggested here occur in the lower- and middle-income marginal rates.

Potential New Income Tax Rate Schedule:

Taxable Income	Marginal Rate
\$0-\$5,080	1.75%
\$5,081-\$10,160	3.00%
\$10,161-\$15,240	4.25%
\$15,241-\$20,320	6.00%
\$20,321-\$25,400	7.25%
\$25,401-\$30,480	8.50%
\$30,481-\$45,720	9.50%
Over \$45,720	9.80%

These three changes in the income tax (no deduction for federal taxes, no capital gains exclusion, and a different rate schedule) are compared to the current rate schedule in Table Two.

TABLE TWO:
COMPARISON OF CURRENT INCOME TAX SYSTEM TO ALTERNATIVE SYSTEM.

CURRENT SYSTEM

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200
Tax as a % of income	**2.1%**	**3.3%**	**3.6%**	**4.0%**	**4.3%**	**4.3%**	**5.5%**
Ave Payment	213	761	1,246	1,904	2,976	8,397	34,662

ALTERNATIVE SYSTEM:
No Federal Deductibility, No Capital Gains Exclusion, New Rate Schedule.

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200
Tax as a % of income	**1.2%**	**2.4%**	**3.1%**	**3.9%**	**4.9%**	**6.7%**	**8.0%**
Ave Payment	119	569	1,078	1,867	3,397	12,933	50,362

Additional Revenue Raised: \$170 million

Eliminating loopholes and adjusting marginal rates yields impressive results. The income tax burden on the poorest quintile is decreased from 2.1 percent of income to 1.2 percent while the burden on middle-income families (\$34,000 annually) is reduced from 3.6 percent of income down to 3.2 percent. In fact, this alternative proposal gives 80 percent of the population a **tax cut** while raising \$170 million in additional revenue. The only group that experiences a tax hike is the best-off quintile—that richest twenty percent of the people who for so long have benefitted from the loopholes that riddled the tax code and have thus escaped paying their fair share.

Sales & Excise Taxes in Iowa

IN THE PAST, WHEN IOWA HAS NEEDED TO RAISE MONEY, the government has usually looked toward increasing sales and excise taxes. The legislative record speaks for itself:

- in 1982, the state sales tax was raised from 3 percent to 4 percent;
- since 1978, cigarette excise taxes have jumped four times, virtually tripling;
- gasoline taxes have been boosted five times in the last ten years, including a January 1989, increase to 20 cents per gallon.

In fact, these two forms of taxation comprised almost 44 percent of the total state tax collections in FY 1988. Unfortunately, sales and excise taxes are also among the most regressive taxes a state can impose. A summary of the current distributional burdens of Iowa's sales and excise taxes is shown below.

TABLE THREE: CURRENT IOWA SALES AND EXCISE TAX BURDENS (as shares of family income)

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	*Average*
Ave. Income	$10,153	$23,296	$34,423	$47,710	$69,763	$193,155	$613,200	*$43,238*
Tax. Spending/Inc	63%	51%	46%	42%	39%	28%	20%	*41%*
Sales Tax/Income	2.6%	2.1%	1.8%	1.7%	1.6%	1.1%	0.8%	*1.6%*
Cig. Tax/Income	0.9%	0.6%	0.4%	0.3%	0.2%	0.0%	0.0%	*0.3%*
Gas Tax/Income	1.9%	1.2%	1.0%	0.9%	0.7%	0.3%	0.1%	*0.8%*
TOTAL/Income	**5.4%**	**3.8%**	**3.2%**	**2.8%**	**2.4%**	**1.5%**	**1.0%**	***2.7%***

The source of the regressivity of these taxes is illustrated by the row called "Taxable Spending/Income." This measures the share of income that pays for items subject to the general sales tax. The average for all income groups is 41 percent. But for families in the lowest income quintile, 63 percent of their income is spent on items that are included in the sales tax base while only 20 percent of the income of the very rich is spent on taxable items.

Table Three also shows that the first three income quintiles (families making below $34,000 per year) are paying sales and excise taxes far above the state average. The poorest twenty percent of Iowa families paid *twice* the average share of income in sales and excise taxes. The 5.4 percent of income the poor pay in sales and excise taxes represents a *three and a half times* greater share of income than families making $193,000 per year.

Although Iowa's sales and excise taxes have always been unfair to lower income families, the degree of regressivity was greatly increased in the spring of 1988 when the state legislature voted to increase gasoline and cigarette excise taxes. The gas increase was a two step process: it was immediately raised from 16¢ to 18¢ per gallon and in January of 1989, the rate jumped to 20¢ per gallon. Similarly, cigarette taxes were raised from an already high level of 26¢ per pack to 34¢ per pack, second highest in the nation. However, effective July 1, 1989, cigarette taxes will decrease to 31¢ per pack under the "Sunset" provision.

By raising these two excise taxes, the legislature perhaps thought they could raise a lot of additional money relatively painlessly. And, though approximately $40 million extra will be realized, the taxes are far from painless. The table below compares the distributional burdens of excise taxes in January 1988 to those of January 1989, when excise taxes were pushed to higher levels. By comparing the two years, we can see which income groups were most effected by the excise increase and by how much.

TABLE FOUR: THE IMPACT OF INCREASED EXCISE TAXES.
(as shares of family income)

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	*Average*
TOBACCO TAXES								
Tob Tax/Inc (1/88)	0.8%	0.5%	0.3%	0.2%	0.1%	0.0%	0.0%	*0.2%*
Tob Tax/Inc.(1/89)	1.0%	0.6%	0.4%	0.3%	0.2%	0.0%	0.0%	*0.3%*
GASOLINE TAXES								
Gas Tax/Inc (1/88)	1.6%	1.0%	0.8%	0.7%	0.6%	0.3%	0.1%	*0.7%*
Gas Tax/Inc (1/89)	1.8%	1.1%	0.9%	0.8%	0.6%	0.3%	0.1%	*0.8%*
TOTALS:								
Diff. from 1988-89:	0.35%	0.21%	0.16%	0.12%	0.09%	0.03%	0.01%	*0.12%*
Magnitude:	**10.0**	**6.1**	**4.5**	**3.5**	**2.5**	**1.0**	**0.4**	*2.9*

The eight cent increase in the cigarette excise makes the first income quintile pay almost **three and a half times** the average share of income and **twenty three** times more than the richest five percent in additional taxes. Middle-income families pay almost **ten** times more of their income in added taxes than families in the top five percent.

Increased gasoline excise taxes also hurt the lower- and middle-income groups far more than the rich. A two cent increase in the cost of gasoline takes **six times** as large a share of income for families in the first quintile than those in the top five percent.

The combined effects of these two tax increases fall most heavily on those families least able to bear the burden. The first income quintile experiences an increase **three times** the average. In fact, the new gasoline and cigarette taxes will take **ten** times the share of income from low-income families than from those families in the top five percent.

Higher excise taxes do indeed raise additional revenue, but they do so at great and inequitable costs. Iowa's steps toward meaningful tax reform should include some form of sales and excise tax relief.

A LESS REGRESSIVE OPTION

An alternative program giving substantial relief to low- and middle- income quintiles would be to reduce excise taxes. Gasoline taxes would decrease to 18¢ per gallon while the "Sunset" provision would roll back cigarette taxes to 31¢ per pack.

Here is what the income distributions would look like:

TABLE FIVE: SALES AND EXCISE TAX REDUCTION

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	*Average*
Ave. Income	$10,153	$23,296	$34,423	$47,710	$69,763	$193,155	$613,200	*$43,238*
Sales tax/Inc	2.6%	2.1%	1.8%	1.7%	1.6%	1.1%	0.8%	*1.6%*
Tobac. Tax/Inc	0.9%	0.5%	0.4%	0.3%	0.1%	0.0%	0.0%	*0.3%*
Gas Tax/Income	1.7%	1.1%	0.9%	0.7%	0.6%	0.3%	0.1%	*0.7%*
TOTAL/Income	**5.1%**	**3.6%**	**3.1%**	**2.7%**	**2.3%**	**1.5%**	**0.9%**	***2.6%***

Allowing the cigarette excise tax to decrease by 3¢ per pack benefits the first income quintile **68** times more as a share of income than it does the richest 0.7 percent and **23** times more than those families in the top five percent. Middle-income families in the third quintile receive **ten** times more relief as a share of income than the richest five percent.

Freezing the gasoline excise at 18¢ per gallon benefits families in the first income quintile almost **six** times more as a share of income than those in the top five percent. Similarly, **three** times more relief is granted to middle-income families than to families in the top five percent.

The revenue losses associated with excise tax relief are relatively small. Reducing the cigarette excise by three cents costs the Iowa Treasury only $8 million per year and the cost of freezing gasoline taxes at 18¢ is roughly $31 million per year. This $40 million loss in revenue can be easily offset by increases in progressive taxes.

Property Taxes in Iowa

RESIDENTIAL PROPERTY TAXES ARE A SIGNIFICANT PROBLEM for low-and moderate-income Iowans. The burden of this tax on the lowest quintile is particularly onerous. A look at the property tax burdens for each of the seven income groups in Des Moines will give an idea of the problem:

TABLE SIX: CURRENT PROPERTY TAX BURDENS IN DES MOINES

Quintile	I	II	III	IV	V,15	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	631,200
Dollar Amount	**$673**	**$800**	**$960**	**$1,239**	**$1,772**	**$3,675**	**$9,427**
Share of Income	**6.6%**	**3.4%**	**2.8%**	**2.6%**	**2.5%**	**1.9%**	**1.5%**

According to the data, the first quintile pays over **three and a half** times as large a share of income in property taxes as do the richest five percent of families. Asking those who are barely making ends meet to cough up 6.6 percent of their income in property taxes is horribly unfair and places an unconscionable absolute burden on the neediest members of the community.

The regressiveness of the residential property tax is evident over the entire range of income groups. But most glaring is the situation of the first quintile. Unfortunately, it is difficult to design a progressive residential property tax system because, in most cases, the only type of property owned by the less affluent comes in the form of housing while the rich have much more diversified holdings of property and wealth. Furthermore, the property tax is a local tax so the state has a limited role in its design. Nonetheless, it is possible, using state-funded relief mechanisms, to make the tax less burdensome.

The relief mechanisms currently in use consist of a homestead credit and a circuit breaker. The homestead credit applies to all homeowners and is an amount equal to the levy on the first $4,850 of actual value for each homestead (about $180 in tax savings).

The circuit breaker in Iowa grants only minor relief to a small percentage of the population—only residents aged 65 or older, surviving spouses aged 55 or older, and disabled people are eligible for the circuit breaker. The value of this tentative circuit breaker credit is a percentage of property tax due (see appendix).

However, the actual value of the credit is determined by subtracting from the tentative credit the amount of the homestead credit. In other words, for qualified low-income families, the value of the circuit breaker is greatly reduced by the homestead credit.

A LESS REGRESSIVE OPTION:

Given the limited scope of the Iowa's current property tax relief system, Citizens for Tax Justice has proposed several alternative plans that provide property tax relief for all low-income taxpayers, not just the elderly and the disabled (see appendix). For example, one possible alternative that gives much-needed relief to the first two quintiles is a program that extends the circuit breaker to all qualified families, broadens the eligibility brackets by a factor of two and a half, and does not subtract the homestead credit from the circuit breaker.

A comparison of the current property tax system with this alternative is shown in table seven:

TABLE SEVEN: COMPARISON OF CURRENT PROPERTY TAX SYSTEM WITH ALTERNATIVE PLAN

CURRENT SYSTEM

Income Quintile	I	II	III	IV	V,15	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Ave payment	$673	$800	$960	$1,239	$1,772	$3,675	$9,427
% of income	6.6%	3.4%	2.8%	2.6%	2.5%	1.9%	1.5%

ALTERNATIVE SYSTEM: Extend the Circuit Breaker, with Brackets Multiplied by two-and-a-half, and with no Subtraction of the Homestead Credit.

Income Quintile	I	II	III	IV	V,15	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Tax payment	$180	$659	$960	$1,239	$1,772	$3,675	$9,427
% of income	**1.8%**	**2.8%**	**2.8%**	**2.6%**	**2.5%**	**1.9%**	**1.5%**

Difference in Revenue: −$105 million

Though this new program would cost about $105 million, it would provide substantial property tax relief to those families who need it the most. The property tax burden for the first quintile drops to 1.8 percent from 6.6 percent and for the second quintile, the burden would decline to 2.8 percent of income from 3.4 percent.

There is a clear and unsurprising tradeoff between the cost of the proposals and the amount of relief they provide. But the need for property tax relief is great, especially for the lowest quintile, and the state should make a significant commitment to alleviating this burden.

The Bottom Line

COMBINING THE ALTERNATIVE INCOME, PROPERTY, SALES AND EXCISE TAX PROGRAMS outlined above creates a reform plan with the following elements:

▪ Eliminate the two largest loopholes from the income tax code. Allowing a deduction for federal income taxes and a 60 percent capital gains exclusion robs the state treasury of enormous sums of revenue and disproportionately benefits the very wealthy. Also, a new, more progressive rate structure (see page 4) can be adopted.

▪ Sales/excise tax relief can be granted by freezing gasoline taxes at 18¢ per gallon and permitting cigarette excises to decrease to 31¢ per pack. These two reductions cost approximately $40 million annually, but overwhelmingly benefit low- and middle-income families. In fact, an excise freeze benefits families below the poverty line 10 times more as a share of income than the richest five percent.

▪ For property tax relief, the circuit breaker could be extended to everyone (not just the elderly and disabled), the eligibility brackets broadened by a factor of 2.5, and the total value of the credit figured by adding the homestead exemption to the circuit breaker, instead of subtracting it. This extensive relief scheme would cost approximately $105 million annually, but would benefit all families with annual incomes of $30,000 or less.

How does this alternative plan compare with the present tax system?

TABLE EIGHT: THE CURRENT STATE TAX SYSTEM IN IOWA, 1989

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	$10,153	$23,296	$34,423	$47,710	$69,763	$193,155	$613,200
Income Tax/Income	2.1%	3.3%	3.6%	4.0%	4.3%	4.3%	5.5%
Sales & Excise/Income	5.4%	3.8%	3.2%	2.8%	2.4%	1.5%	1.0%
Property Tax/Income	6.6%	3.4%	2.8%	2.6%	2.5%	1.9%	1.5%
TOTALS	**14.1%**	**10.5%**	**9.6%**	**9.4%**	**9.2%**	**7.7%**	**8.0%**

TABLE NINE: FIRST ALTERNATIVE TAX SYSTEM

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	$10,153	$23,296	$34,423	$47,710	$69,763	$193,155	$613,200
Income Tax/Income	1.2%	2.4%	3.1%	3.9%	4.9%	6.7%	8.0%
Sales & Excise/Income	5.1%	3.6%	3.1%	2.7%	2.3%	1.5%	0.9%
Property Tax/Income	1.8%	2.8%	2.8%	2.6%	2.5%	1.9%	1.5%
TOTALS	**8.1%**	**8.8%**	**9.0%**	**9.2%**	**9.7%**	**10.1%**	**10.4%**
Change from Current Law Under Alternative 1:	**−6.0%**	**−1.7%**	**−0.6%**	**−0.2%**	**+0.5%**	**+2.4%**	**+2.4%**

Additional Revenue Raised: $25 million

This alternative solution makes the state tax system truly progressive. Eighty percent of Iowa's families pay less under this alternative than they do under the current program. For the first quintile, the tax burden drops from 14.1 percent of income down to 8.1 percent, a decrease of over 40 percent while the burden for the richest five percent climbs from 7.7 percent to a much fairer 10.1 percent.

Another measure of tax fairness is to divide the percent of income the richest five percent pay in taxes by the percentage paid by the poorest quintile. The larger the quotient, the more progressive in the tax. For the current system, the figure is 0.55, meaning that the richest five percent of families only contribute as a share of income 55 percent of what the poor do. However, under the first alternative solution, the rich tax/poor tax jumps up to 1.23, meaning that the richest five percent are now paying 23 percent more as a share of income than the poorest quintile. Thus, the overall state tax system finally would tax according to a family's ability to pay.

With this alternative comes additional net revenue of $25 million. This could be used to provide additional tax relief or to help finance much-needed roads, schools, job retraining programs, and the like.

ALTERNATIVE TWO

If there is reluctance to change income tax rates, or if the state does not want a tax plan that raises additional revenue, then a second alternative could be adopted. This approach would use the current marginal rates, eliminate the deduction for federal income taxes and the capital gains loophole while doubling the standard deduction and personal credit (see appendix). The excise and property tax relief programs would remain unchanged from the first alternative.

This second alternative system would have the following distributional effects:

TABLE TEN: SECOND ALTERNATIVE TAX SYSTEM

Quintile	I	II	III	IV	Top 15%	Top 5%	Top 0.7%
Income	$10,153	$23,296	$34,423	$47,710	$69,763	$193,155	$613,200
Income Tax/Income	0.7%	3.0%	3.4%	3.9%	4.5%	6.5%	7.9%
Sales & Excise/Income	5.1%	3.6%	3.1%	2.7%	2.3%	1.5%	0.9%
Property Tax/Income	1.8%	2.8%	2.8%	2.6%	2.5%	1.9%	1.5%
TOTALS	**7.6%**	**9.4%**	**9.4%**	**9.2%**	**9.5%**	**9.9%**	**10.3%**
Change from Current Law Under Alternative 2:	**−6.5%**	**−1.1%**	**−0.3%**	**−0.2%**	**+0.3%**	**+2.1%**	**+2.3%**

Additional Revenue Raised: None

This second alternative, which is revenue neutral, again is a better tax deal for 80 percent of Iowa families than is the present system. The first four quintiles realize a net decrease in their tax bills. The tax burden on the lowest income group is lowered by over 46 percent and the rich tax/poor tax quotient is 136%, an increase of almost 80 percentage points.

Although both alternative programs substantially increase the progressivity of Iowa's overall tax system, the first solution may be preferable, because it gives more relief to families making less than $47,000 annually and it raises $25 million more, which can be used for added relief or to pay for needed public services.

Conclusion

IOWA DESPERATELY NEEDS EFFECTIVE TAX REFORM. The tax policies adopted by the Iowa state legislature over the last last five years have heaped staggeringly unfair burdens on low- and middle-income families while letting the rich off relatively easily. The alternative tax proposals outlined above (along with other possibilities included in the appendix) illustrate how reform can be achieved. It's time to get to work and make the state tax system a good deal for the majority of Iowa families, not just the very wealthy.

APPENDIX

METHODOLOGICAL NOTES

The income numbers for the quintiles are based on state-by-state income data from the U.S. Bureau of the Census updated to 1989 based on the growth in personal income.

Income taxes were calculated using a computer model from Citizens for Tax Justice's January 1987 report *The Sorry State of State Taxes*. Data and calculations were based on state tax forms and instructions for 1985 and updated for statutory changes and indexing for 1989.

Sales and excise taxes were based on a model from CTJ's March 1988 report *Nickels & Dimes* which uses adjusted Consumer Expenditure Survey data to calculate the burdens on different income groups.

Property taxes for Des Moines were calculated using several sources. Average home values for homeowners by quintile were computed based on data from Census bureau and updated for 1989 based on nationwide growth in the cost of fixed residential investment. The effective assessment ratio (the assessed value over the sales value of the property) was obtained from local revenue officials. The taxable value was arrived at by multiplying the assessed home value by the classification rate (percent of the assessed value subject to taxation. The mill rate (obtained again from local officials) is then multiplied by the taxable valuation to arrive at a tax figure (before credits). Because the Census data were incomplete for high-income families, IRS figures were used for property tax deductions.

The figures are weighted averages of homeowners and renters in each quintile. The percentage of homeowners and renters in each income group and gross rent by quintile was calculated using Census data. A fixed percentage of gross rent was determined to constitute property tax burden.

INCOME TAX NOTES

Below are the Iowa income tax rates in 1985 and in 1989:

1985 Schedule:

Taxable Income	Marginal Rate
$0-$1,000	0.4%
$0-$1,023	0.5%
$1,024-$2,046	1.25%
$2,047-$3,069	2.75%
$3,070-$4,09	3.5%
$4,093-$7,161	5.0%
$7,162-$9,207	6.0%
$9,208-$15,345	7.0%
$15,346-$20,460	8.0%
$20,461-$25,575	9.0%
$25,576-$30,690	10.0%
$30,691-$40,920	11.0%
$40,921-$76,725	12.0%
Over $76,725	13.0%

1989 Schedule:

Taxable Income	Marginal Rate
$1,017-$2,032	0.8%
$2,033-$4,064	2.7%
$4,065-$9,144	5.0%
$9,145-$15,240	6.8%
$15,241-$20,320	7.2%
$20,321-$30,480	7.55%
$30,481-$45,720	8.8%
Over $45,721	9.8%

Note: the standard deduction remains at 15% of Adjusted Gross Income or $1,230 (single)/$3,030 (joint), whichever is smaller. This is up only slightly (by $30) from 1985. The Personal Credit is unchanged at $20 (single), $40 (joint) and $15 for each dependent. The state would have done well to give tax relief here, through the standard deduction and personal credit which primarily benefit low- and moderate income taxpayers rather than reducing the top rates.

Additional Income Tax Proposals

The following pages survey a number of potential income tax changes, examining their tax burden distributions for families of four at seven different income levels. The tables also show average family income by quintile, average tax payment as a share of income and in terms of dollars, and changes in average payments from the system as it exists now, along with rough revenue estimates for the various proposals:

1. The 1985 system, with the rate schedule ranging from 0.5% to 13%.

2. The current system in 1989.

3. The present system except with no deduction for federal taxes. Every bracket except the bottom experiences a tax hike, but the amount of the hike increases as income rises. The second quintile goes from paying 3.3% of its income to paying 3.7% whereas the Top 5% go from paying 4.4% to paying 6.3%. This program illustrates the extent of the revenue loss and decrease in progressivity that allowing a deduction for federal income taxes produces.

4. The same as in three except with the elimination of the capital gains exclusion as well as elimination of the deduction for federal taxes. This program raises the most revenue of any of the plans examined here. It also dramatically improves progressivity.

5. In this case, there is no deduction for federal taxes, no capital gains exclusion and the standard deduction and personal credits are doubled. The bottom 80% of the population enjoys a tax cut. The cut is biggest for the lowest quintile which would now pay only 0.7%. In spite of the tax cuts, this proposal would raise quite a bit of revenue, all from the top 20% (and most of that from the top 5%).

Distributional impacts of various additional income tax proposals

1. Old Law (1985)

1985 DOLLARS

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	Average
Ave Family Income	7,909	18,147	26,816	37,166	54,345	150,469	491,708	
as a % of income	**1.7%**	**2.6%**	**2.9%**	**3.3%**	**3.6%**	**3.7%**	**3.2%**	**3.2%**
Ave Payment	111	527	930	1,428	2,343	6,345	17,510	1,577

2. Current Law (1989)

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	Average
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200	
as a % of income	**2.1%**	**3.3%**	**3.6%**	**4.0%**	**4.3%**	**4.4%**	**5.5%**	**3.9%**
Ave Payment	216	768	1,255	1,913	2,993	8,424	34,702	1,700

3. No Deduction for Federal Taxes

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	Average
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200	
as a % of income	**2.1%**	**3.7%**	**4.3%**	**4.8%**	**5.5%**	**6.3%**	**7.7%**	**5.0%**
Ave Payment	216	862	1,475	2,279	3,822	12,234	48,743	2,151

Additional Revenue Raised: **$403 million**

4. No Deduction for Federal Taxes, No Capital Gains Exclusion

Quintile	I	II	III	IV	V,15%	Top 15%	Top 0.7%	Average
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200	
as a % of income	**2.1%**	**3.7%**	**4.3%**	**4.8%**	**5.5%**	**6.9%**	**8.0%**	**5.1%**
Ave Payment	216	866	1,483	2,297	3,860	13,373	50,801	2,220

Additional Revenue Raised: **$465 million**

**5. No Deduction for Federal Taxes, No Capital Gains Exclusion,
Doubled Standard Deduction & Personal Credit**

Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%	Average
Ave Family Income	10,153	23,296	34,423	47,709	69,762	193,155	631,200	
as a % of income	**0.7%**	**3.0%**	**3.5%**	**3.9%**	**4.5%**	**6.5%**	**7.9%**	**4.3%**
Ave Payment	72	704	1,194	1,856	3,152	12,546	49,947	1,865

Additional Revenue Raised: **$147 million**

In terms of progressivity, proposal five (along with the one described in the text) is the best. However, each plan raises additional revenue which can be used to provide even more tax relief for the low- and middle- income families from sales, excise, and property taxes. The other proposals examined also make the income tax more progressive, raise even more revenue, but do not, by themselves, offer any income tax relief to any groups (although the lowest quintile is not affected in any of the proposals). The question of which program is best depends on the state's revenue needs and the political imperatives of passing a tax reform proposal. Any of these choices offers most Iowans a far better deal than the current system.

PROPERTY TAX NOTES

Current rules regarding the Circuit Breaker and the Homestead Credit:

Homestead Credit: (For the owner of a dwelling, which the owner occupies for six months or more.) The credit is in an amount equal to the actual levy on the first $4,850 of actual value for each homestead, with a minimum credit of $62.50. (More for poor disabled veterans).

Circuit Breaker for Iowa residents aged 65 or older, surviving spouses aged 55 or older, and disabled. For the following income groups, the percentage below is the share of property tax due or rent constituting property tax paid which is allowed as (tentative) credit or reimbursement

Current Circuit Breaker

Taxable Income	**Credit (as % of property tax due)**
0-$4,999	100%
$5,000-$5,999	70%
$6,000-$6,999	50%
$7,000-$7,999	40%
$8,000-8,999	30%
$9,000-$11,999	25%

The actual credit is determined by subtracting from the tentative credit (above) the amount of the homestead credit which was allowed as a credit against property taxes due in the fiscal year following the base year by the claimant.

The actual reimbursement for rent statutorily deemed to constitute property taxes paid (27.5% of gross rent) is equal to the tentative reimbursement. If property taxes, or rent constituting property taxes, are over $1,000, the amount of property tax due or rent constituting property tax paid is deemed to be $1,000.

The proposed Circuit Breaker (brackets multiplied by 2.5). See page 9 above.

Taxable Income	Credit (as a % of property tax due)
$0-$12,499	100%
$12,500-$14,999	85%
$15,000-$16,999	70%
$17,500-$19,999	55%
$20,000-$24,999	40%
$25,000-$29,999	25%

Alternative Plans for Property Taxes

Below are descriptions of alternative property tax systems that also could replace the current one. The distributional effects for various income groups are shown, along with revenue estimates and the average payment each family would have under each plan.

1. The current property tax system.

2. The circuit breaker could be extended to all lower income families and instead of its value being decreased by subtracting the homestead exemption, the new value simply is that percentage shown in the table entitled **Current Circuit Breaker.** This alternative would cost about $28 million, but would decrease the property tax burden for the first quintile to 5.0 percent of income from 6.6 percent. (Note: doubling the value of the circuit breaker would double the cost to $56 million, and would reduce the property tax burden of the first quintile to 3.3 percent.)

3. In order to give the second, third, and fourth quintiles a stake in property tax reform, they must be given some measure of relief. If the homestead exemption were doubled with the same circuit breaker policy as in #2, then most income groups would see a significant reduction in their property tax bills, at a cost of approximately $130 million.

4. If the homestead exemption were doubled, the circuit breaker doubled, and the value of the circuit breaker calculated without subtracting the homestead credit, then maximum relief would be granted. The property tax burden for families in the first quintile would drop to 0.9 percent, while those for other income groups would remain the same as in program three. However, the cost of this program is great, on the order of $180 million.

5. Extend the circuit breaker to all families and extend the eligibility brackets by two-and-a-half. This plan is discussed in the text and gives the greatest amount of relief to the first two quintiles while costing about $105 million.

Distributional burdens and revenue costs of additional alternative property tax relief programs.

1. Current property tax system

Income Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Ave payment	$673	$800	$960	$1,239	$1,772	$3,675	$9,427
% of income	6.6%	3.4%	2.8%	2.6%	2.5%	1.9%	1.5%

Average payment (total) $1,184 per household

2. Extend the circuit breaker to all low-income taxpayers without subtracting homestead credit.

Income Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Credit	$168	$0	$0	$0	$0	$0	$0
tax payment	$504	$800	$960	$1,239	$1,772	$3,675	$9,427
% of income	5.0%	3.4%	2.8%	2.6%	2.5%	1.9%	1.5%

Average Payment (total) $1,150 per household
Revenue Loss: −$28 million

3. Double homestead credit without subtracting homestead credit from circuit breaker.

Income Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Credit	$528	$360	$360	$360	$360	$360	$360
tax payment	$430	$696	$833	$1,093	$1,613	$3,504	$9,248
% of income	4.2%	3.0%	2.4%	2.3%	2.3%	1.8%	1.5%

Average Payment (total) $1,028 per household
Revenue Loss: −$130 million

4. Double homestead credit, double circuit breaker, no subtraction.

Income Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
tax payment	$947	$696	$833	$1,093	$1,613	$3,504	$9,248
% of income	0.9%	3.0%	2.4%	2.3%	2.3%	1.8%	1.5%

Average Payment (Total) $960 per household
Revenue Loss: −$180 million

5. Extend the circuit breaker, with brackets multiplied by two-and-a-half.

Income Quintile	I	II	III	IV	V,15%	Top 5%	Top 0.7%
Income	10,153	23,296	34,423	47,710	69,763	193,155	613,200
Tax payment	$180	$659	$960	$1,239	$1,772	$3,675	$9,427
% of income	1.8%	2.8%	2.8%	2.6%	2.5%	1.9%	1.5%

Average Payment (total) $1,057 per household
Revenue Loss: −$105 million