

PUTTING FAIRNESS FIRST

Questions for Financing State and Local Government in Iowa

As state legislators close out the 2008 legislative session and confront the tasks of maintaining commitments and investing in Iowa's future, they will have to deal with a basic question: How is the budget gap to be financed?

Each financing decision has a different set of consequences for Iowans at different income levels. This means that, when answering the question of how to finance important state programs during a budget shortfall, it is crucial to remember a basic principle of taxation: fairness.

It is also important that a tax system include a combination of each type of tax — property, sales, individual income and corporate income — since each relies on a different revenue stream that will respond differently to economic growth and decline. Diversity in tax sources adds stability to the revenue stream. Tax systems should also maintain a level playing field for all taxpayers by not distorting economic decision-making or allowing tax avoidance through leaky seams in the tax code.

The first month of the 2008 legislative session has highlighted the importance of making good choices around tax policy in Iowa. For instance, legislators have considered a proposal to make funding for Iowa's natural resources more sustainable by passing a constitutional amendment that would dedicate a share of state sales tax revenue to natural resources funding. The share would be equivalent to a tax rate of three-eighths of 1 percent. Another proposal under consideration would convert existing 1-cent local option sales taxes for school funding into a statewide 1-cent tax in order to facilitate redistribution and sustainability of the funding.

Sustainable funding for all of our public services, including natural resources and education, is crucial. When legislators make choices about how to fund these public services, they also make fundamental choices about the structure of state taxes. In order for our tax system to be both equitable and structurally sound, so that it can continue to provide a sustainable foundation for state revenue, these choices must be made with fairness in mind.

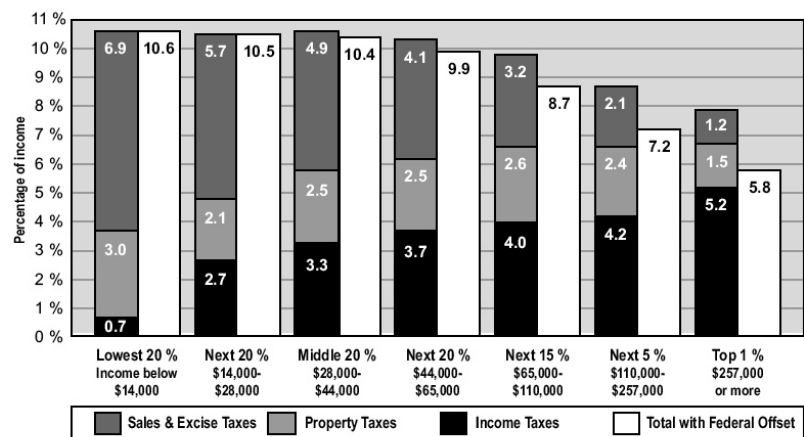
IOWA'S TAX SYSTEM FAILS THE 'ABILITY TO PAY' PRINCIPLE

A primary criterion for tax fairness is whether the system is based on an ability to pay.

Many features of Iowa's tax system are not fair. Working families and low-income households pay a higher share of their income in state taxes than many other Iowans, including upper-income households.

Figure 1 at right, from the Institute on Taxation and Economic Policy's analysis of the Iowa tax system,¹ shows that Iowans in the lowest four income quintiles pay more in state and local taxes as a share of their family income

Lower Income, Higher Tax Rate in Iowa
State and Local Tax by Share of Family Income, Non-Elderly Taxpayers, 2002



Source: Institute on Taxation and Economic Policy

The Iowa Policy Project

120 N. Dubuque St. #208
Iowa City, IA 52245
(319) 338-0773 • www.iowapolicyproject.org

Child & Family Policy Center

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

than the top 20 percent, and significantly more than the top 1 percent of Iowa taxpayers. As Figure 1 shows, different kinds of taxes affect Iowa families differently, depending on their income. For Iowans in the lowest income quintile, sales and excise taxes account for the largest share of their taxes (6.9 percent of income) while income taxes are the smallest (0.7 percent of income).

Income taxes are based on a taxpayer's ability to pay, such that families with lower incomes pay a lower percentage of their income in income taxes compared with high-income families. On the other hand, sales and excise taxes and property taxes are levied without regard to a family's income. Both wind up taxing lower-income families more heavily than higher-income families as a share of income, making them "regressive" taxes. The sales tax is the most regressive in this regard.

TAX POLICY SINCE 1990 HAS MADE THE TAX SYSTEM LESS FAIR

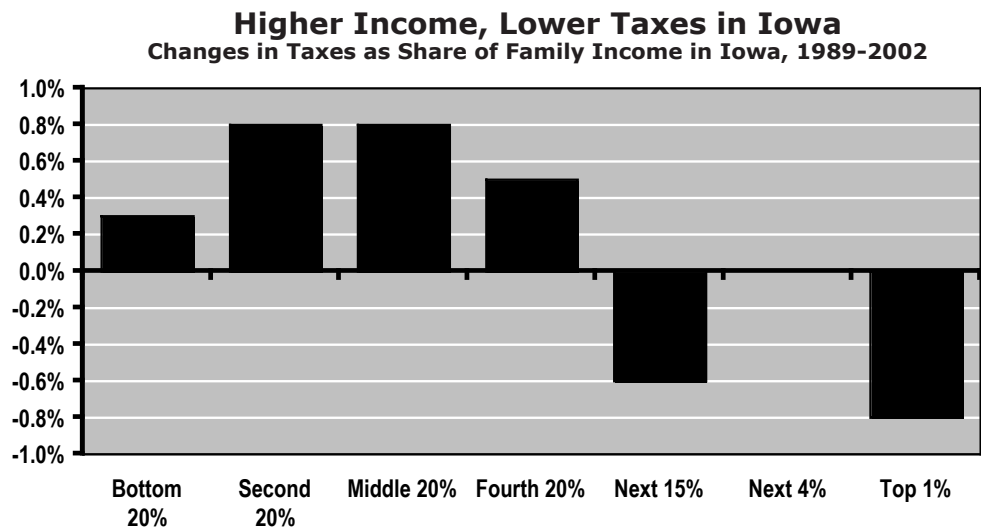
Another key principle of tax fairness is that changes to the tax system should be designed to produce a fairer overall system to finance essential public services. In other words, changes to a tax system should move the overall system closer to being based on an ability to pay. This has not been the case in Iowa, particularly since 1990. Figure 2 shows how taxes as a share of income have increased for Iowa families in the lowest quintiles of income while taxes for those in the upper quintiles of income have actually decreased.²

These shifts in state and local taxes occurred as a result of several tax policy changes, most of which disproportionately and negatively impacted low-income households. The state sales tax increased from 4 percent to 5 percent in 1992, and further legislation authorized the use of two local option sales

taxes. As a result, the state and local sales tax rate has gone from 4 percent in 1990 to nearly 7 percent in 2008. Property tax reductions have been largely financed by this expansion of the sales tax, meaning that one regressive tax has been mitigated by increases in an even more regressive tax.

State income tax cuts in 1997 benefited upper-income brackets in comparison to low- and middle-income Iowa families by making across-the-board cuts of 10 percent. Although across-the-board cuts in tax rates may seem proportional at first glance, they actually make the tax system less fair because they cut overall taxes on upper income taxpayers much more than lower income tax payers.

Relatively few major tax policy changes in recent years have improved the fairness of Iowa taxes. In 2000, lawmakers passed a utility sales tax exemption, which benefited low-income earners for whom utility costs make up a higher percentage of their income. In 2007, low-income Iowans also benefited from the expansion of the state Earned Income Tax Credit (EITC), which was also made refundable, to reach low-income earners with little or no income tax liability. Refundability enables the EITC to offset other taxes, such as sales and property taxes, for those households that benefit. But together these two tax changes are small in comparison to the major changes of the past 15 years that have resulted in a nearly 75 percent increase in the sales tax and a cut in income taxes for upper-income brackets.



WHAT SHOULD WE DO NOW?

Overall, tax policy changes since 1990 have made the Iowa tax system less fair for working and low-income families. As policymakers work to address current budget shortfalls, they should resist further moves that shift tax responsibilities from upper-income households to low- and middle-income households.

How can we do it? There are several options to do so, including:

- Avoid increasing sales taxes.
- Increase state revenue by closing loopholes that benefit individuals as well as corporations and return Iowa's tax code to its original intent.
- Give local governments fairer options for supporting city and county budgets, such as a local income tax.

Several measures would raise substantial revenue in a progressive fashion by closing tax loopholes or ending ineffective giveaways that largely benefit wealthy Iowans or large corporations. Adopting combined reporting legislation would raise \$60 million to \$100 million a year by thwarting efforts by multistate companies to shift profits out of Iowa to avoid Iowa's corporate income tax. Limiting the refund that corporations can receive from the research activities credit (RAC), for instance to an annual maximum of \$100,000, would save the state \$26 million a year. Similarly, limiting Iowa's current unique treatment of capitals gains, in which all capital gains income is exempted from taxation, by taxing capital gains income above \$200,000 would raise \$22.7 million each year.

Iowa's cities and counties have few options to raise revenue for better services or to offset property taxes. They can seek a local option sales tax that disproportionately impacts low-income families even more than the property tax. They can also raise fees (these are limited and generally regressive), or adopt a hotel-motel tax that falls under the allowable cap.

Our local governments need progressive alternatives. There is a long-established precedent for equipping localities in Iowa with these kinds of alternatives: School districts have the option of levying an income tax surcharge as part of the instructional support levy. The surcharge is simply a percent of the state income tax the district resident must pay. This is simple and inexpensive to administer and collect. And it is just as progressive as the state income tax.

Legislators and policymakers have choices when it comes to raising revenue for important projects. Increasing the sales tax can be a politically expedient alternative to taking on the task of closing tax loopholes or enabling innovative forms of local taxation. But this doesn't mean it's the best choice for Iowa taxpayers.

¹ Institute on Taxation and Economic Policy (2003) "Iowa Taxes Hit Poor and Middle Class Harder than the Wealthy," Who Pays? A Distributional Analysis of the Tax Systems in All 50 States. Available from: <http://www.itepnet.org/wp2000/ia%20pr.pdf>. For an earlier Iowa Fiscal Partnership analysis based on ITEP's 2003 report, see Fisher, Peter and Charles Bruner (2003) "What Would Real Tax Reform Look Like?" The Iowa Policy Project/Child and Family Policy Center. Available from: http://www.iowapolicyproject.org/2002-2004docs/031021-tax_reform.pdf.

² Institute on Taxation and Economic Policy (2003).