

## Governor's plan sets stage for service cuts

*Reforms for fairness and simplicity could be achieved without losing revenue*

Iowa's lawmakers opened the year with promises for tax reform. Options we identified last fall<sup>1</sup> remain. These include the elimination of federal deductibility and the closing of sales tax loopholes. **A reform package could be done without losing revenue at a time of shortfalls.**

Sensible tax reform could include:

- Eliminating federal deductibility and adjusting rates
- Modernizing sales tax for 21<sup>st</sup> century to reflect new services, e-commerce and remote sales
- Closing tax loopholes in corporate and individual income tax
- Expanding deductions and credits on individual income tax especially for working families with kids, recognize core costs that shouldn't be subject to tax

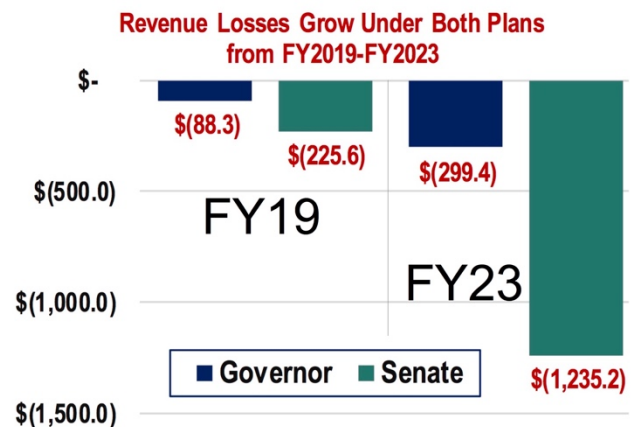
**Key Point:**  
Reforms can be made responsibly, at less or even no cost

**The Governor's plan, House Study Bill 671, does include desirable reforms.** It raises the standard deduction, eliminates federal deductibility, and modernizes the sales tax by extending it to e-commerce. But as with any complex package of tax proposals, the details matter. This plan:

- **Would force cuts in essential public services** due to revenue losses,
- **Fails to enhance fairness** in individual income taxes by recognizing the cost of raising children,
- **Leaves current tax credits in place** and corporate tax loopholes open,
- **Creates a costly new business break:** the Qualified Business Income Deduction, and
- **Provides far greater benefits to the wealthy** than to moderate- or low-income Iowans.

### Needed: Adequate revenues

A central focus of tax reform, especially given current circumstances, should be adequate revenues. Yet, on top of the deficit for the current fiscal year, the Governor's plan proposes annual reductions to the state General Fund projected at \$132 to \$299 million. Cuts of this magnitude inevitably would reduce Iowa's ability to maintain quality public education and affordable community colleges and universities, or to address problems with water quality or the mental health system. As shown in the figure at right, the Governor's plan would reduce revenues less than the plan passed by the Senate, but the cuts would be significant, and larger in coming years.



### Needed: Greater fairness in a regressive system

Iowa's overall state-local system of income taxes, sales taxes and property taxes is regressive: It takes a greater share of income of lower-income than wealthier taxpayers. The bottom 80 percent of filers pay about 10 percent of their income in state and local taxes; the top 1 percent pays only about 6 percent.<sup>2</sup>

As the only revenue source that is progressive, the income tax could play a key role in making Iowa’s system based more upon ability to pay, as sales and property taxes remain regressive. Also, the income tax is the largest source of General Fund revenue, making a robust income tax essential for revenue adequacy.

**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 (AMT), (5) a deduction for “pass-through” businesses equal to 25 percent of the new federal qualified business income deduction (QBID) and (6) conformity with federal increases in the Earned Income Tax Credit as of tax year 2018. **It would expand the sales tax base** by closing a number of loopholes that largely result from 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.** Eliminating the federal income tax deduction most affects those at high incomes, but higher earners benefit most from eliminating the AMT and adding the QBID.

The net effect of the first round of income tax changes, for Tax Year 2023, is shown in the table below. **Those with income of \$100,000 or more would gain 56 percent of the tax cuts.** However, the percentage reduction for that group is 8.2 percent, compared to 13.1 percent for those under \$100,000.

**Table 1. 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*

Adjusted Gross Income	Number of Returns	Average Change in Taxes		Percent of Total Tax Reduction	Percent with Decrease	Percent with Increase
		Dollars	Percentage			
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 \$250,000	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. This should be considered in any discussions about further reducing taxes on retirement income, which already has substantial preferences.

### **Two final points**

**First, the plan includes so-called “triggers” that would ratchet down revenue for critical public needs.** The Governor promotes these as protection against tax cuts if revenues fall short; actually, the first and largest round of cuts is immediate, and the triggers assure that Iowa would hold down services when the economy is stronger, and the state could best afford to invest in services already held back.

**Second, the Reynolds administration uses fuzzy math to argue its plan is revenue neutral.** In fact, 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. In other words, the bill by then is a net revenue loser for state and local governments combined. And the General Fund loses from at least fiscal year 2021 forward.

<sup>1</sup> Iowa Fiscal Partnership, “Intro to 2018: Sensible improvements for Iowa tax policy.” October 2017. <http://www.iowafiscal.org/sensible-improvements-for-iowa-taxes/>

<sup>2</sup> 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/>