2018 TAX POLICY KIT

March 27, 2018
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Making household living costs part of mix in tax policy

How to reform Iowa's state income tax to enhance fairness to families

By Charles Bruner for the Iowa Fiscal Partnership

Iowa takes only small steps but could do much more to recognize essential costs families face to support a household and raise children. The standard (or itemized) deduction, personal exemptions, and personal credits on the income tax all seek to recognize these costs. Such exemptions from taxable income (or credits applied to taxes owed) are based upon recognized tax principles of fairness — not taxing those essentials (food, housing, transportation, etc.) that are needed simply to get by. The standard deduction provides a basic recognition of this cost, while the option to itemize deductions enables tax filers to recognize higher costs of specific household expenses (primarily mortgage interest costs, taxes, high medical expenses, and charitable contributions).

Iowa income tax reform must foremost address the cost of raising a family — increasing the Iowa standard deduction and dependent tax credit.

Iowa's current standard deduction already was very small in relation to the federal standard deduction, before changes in the new federal tax cut (Iowa's for 2018 are $2,030 for a single filer and $5,000 for a married joint filer, compared with the federal deductions of $6,500 and $13,000 before the changes). Under the new federal law, standard deductions will increase to $12,000 for a single filer and $24,000 for a married couple filing jointly (although the current personal exemptions are eliminated).

As a result of the low standard deduction, Iowa also has one of the most complex state income tax systems in the country. At the federal level, even before the federal tax cut, 70 percent of tax filers claimed the standard deduction[1] (the figure is expected to rise to 85 percent with the expansion of the deduction). Only about half of Iowa tax filers do.[2] This means, for future tax years, if Iowa does not expand its standard deduction, about 4 in 10 Iowans who claim the federal standard deduction will have to go through the extra and often complicated process of calculating and claiming a state itemized deduction.

When it comes to the costs of raising children, the differences are even greater. Families with children have child-raising expenses that have been estimated at $13,000 per year for a middle-income family.[3] Previously, the federal tax code had provided a $1,000 credit plus a $4,050 personal exemption from income for each child. The federal tax cut legislation eliminated the personal exemption while doubling the child tax credit to $2,000. For a tax filer in a marginal tax bracket of 22 percent, often middle-income families, that credit is equivalent to a deduction of a little over $9,000, a substantial contribution to the $13,000 estimated cost of raising a child.

Iowa, however, has only a $40 credit for each child. For a filer in a 6 percent state income tax bracket, this is equivalent to a deduction of about $670. This is where[4] Iowa's individual income taxes are most out-of-line with the federal income tax and taxes in many other states. A further complication and inequity is that many Iowa families with children and incomes below $50,000 owe Iowa income taxes, but do not owe (and even receive a refund) at the federal level. While the federal tax code works to support working families with children in making ends meet, the current Iowa tax code often does the opposite.

While the federal tax code works to support working families with children in making ends meet, current Iowa tax law often does just the opposite.

Both SF2383 and the Governor's proposal make changes to Iowa's standard deduction, but neither makes changes to Iowa's personal credits for children.

SF2383 essentially adopts the new federal standard deductions ($12,000 for a single individual and $24,000 for a married couple filing jointly). The Governor's proposal raises the standard deduction to $4,000 for a single individual and $8,000 for a married couple filling jointly. Neither, however, would change the personal credits. The Governor's proposal also adds an additional deduction of $1,500 for elderly and blind individuals, which expands the already preferential tax treatment of seniors over working people.[5]

The increases in the standard deduction in both versions have very substantial costs, but also substantial contributions to tax fairness and simplicity in Iowa. In particular, they benefit moderate and middle-income tax filers, especially those who rent and do not have mortgage interest deductions that would increase the housing expense deduction they would claim if itemizing.

Both the Governor's proposal and SF2383 begin to address inequities in Iowa's tax code regarding essential household living costs through the standard deduction expansion. Neither, however, addresses the inequities related to the costs of raising children.

Given the expansion in the standard deduction, one way to better recognize children in the Iowa income tax would be to limit the provision of personal credits to dependents (primarily children) and redirect the cost of the current credits for adults to expand the child tax credit. Another is to ensure that other changes to Iowa's personal income tax (closing loopholes, adjusting rates) make room to increase the dependent credit to better reflect the cost of raising children. Such reforms would enhance fairness in Iowa's income tax.

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[1] *Internal Revenue Service (2017). Individual Income Tax Returns, Preliminary Data, Tax Year 2015. 69.2 percent of returns claimed standard deduction.*
[2] *Iowa Department of Revenue. 2015 Iowa Individual Income Tax Annual Statistical Report. Tables 11 and 12. https://tax.iowa.gov/sites/files/idr/Individual Income Tax Report 2015 Revised.pdf*
[3] *United States Department of Agriculture (2017). Expenditures on Children by Famillies, 2015. 0-18 cost of raising child $233,000 = $13,000 per year.*
[4] *Iowa Fiscal Partnership, Resolving inequities in Iowa taxes, February 2012. http://www.iowafiscal.org/resolving-inequities-in-iowa-taxes/*
[5] *Iowa Fiscal Partnership, Tax reform and seniors: Better focusing on the real need, March 2018. http://www.iowafiscal.org/taxing-seniors-retirees-benefit-already/*

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