

## ***Iowa's Tax Overhaul: Sorting facts, key points from spin***

- *Plan means less revenue for services, greater inequities favoring the wealthy*
- *Early promises of general reform sacrificed for special-interest perks*

By Charles Bruner and Peter Fisher

As Iowa lawmakers consider the agreed-upon tax plan developed by Republican leadership and Governor Reynolds, sharp differences are clear from earlier proposals by the Governor and the House Ways and Means Committee.

**First, the plan diverges from the promise of fundamental income-tax reform**, which would have addressed costly business tax credits, eliminate federal deductibility and better recognize the costs of raising a family. **Notably, the proposal jettisons any increase in the standard deduction** in Iowa's income tax over the next four years. That provision — part of the Governor's and Ways and Means bills — was most directed to moderate and middle-income working families. It would have simplified taxes for many Iowans. Rather than reform the system for equity and simplification, it compounds problems with the current system in both areas.

**Second, middle-class Iowans will benefit little under the plan, despite claims of proponents.** Earlier plans offered bigger percentage cuts at low incomes, while higher-income filers did better overall. The final plan reverses the percentage changes: even bigger breaks at higher incomes.

**Third, special breaks especially skew the changes to favor Iowans with business income, and corporations.** The Qualified Business Income Deduction (QBI) break for "pass through" business income is for filers who report business income on their individual returns. It primarily benefits the highest-income tax filers. The plan also adds a corporate income-tax deduction.

**Fourth, the proposal comes at a far greater cost** than previously proposed by the Governor or House Ways and Means Committee — assuring future cuts in education, public safety and other services that benefit all, to enable the greatest share of tax breaks to the highest-income taxpayers.

**Fifth, experience suggests the plan is more likely to hurt the Iowa economy than to help it.**

Key features of the points above are summarized below.

### ***Standard Deduction***

Iowa's current standard deduction is one of the lowest in the country, at \$2,070 for a single individual and \$5,090 for a married couple filing jointly. Under the new federal law, the standard deductions are \$12,000 for a single individual and \$24,000 for a married couple. The Governor had proposed raising Iowa's standard deduction to \$4,000 for a single individual and \$8,000 for a married couple filing jointly; House Ways and Means proposed \$3,000 and \$7,500, respectively.

Moderate and middle-income families are the primary users of the standard deduction, particularly those who rent and have no mortgage interest to deduct. The standard deduction is an effective way to avoid taxing income that is needed to meet basic household needs.

Abandoning any increase in the standard deduction means the proposal fails to address a major inequity in current law — and directing tax relief to moderate and middle-income Iowa families.

**Tax Rates**

Both the Governor’s proposal and the House Ways and Means Committee made changes to Iowa’s overall tax rates, providing most of rate reductions on the lower tax brackets. The result was a “middle-class mirage,” with the appearance of greater share of the benefits from rate reductions to middle income tax filers, when the greater share of actual tax savings went to wealthier filers.<sup>1</sup>

The new proposal, however, provides greater reductions — and those percentage cuts, while comparable, will be much greater in impact at the top than the bottom brackets. While the Governor’s proposal eliminated federal deductibility and lowered rates commensurately and more detailed analysis has to be provided to show their impacts, the Ways and Means Committee bill and the new proposal simply changed current rates for different income brackets. As shown in Table 1, the cut to the top rate was 1 percent in the Ways and Means proposal but 5 percent in the House proposal. The 4-point difference equates to an additional tax cut of \$4,000 for the 3,200 Iowa filers with incomes over \$1 million, at the cost to the General Fund of \$13 million. The Governor’s argument for reducing rates lower was based on addressing the image of higher taxes caused by having federal deductibility. Despite this cut at the top, the agreed-upon plan’s top rate of 8.53 percent leaves that image in place, and sets the stage for continued debates on tax cuts even after the large cuts in revenues of this legislation.

**Table 1. Final Proposal Enhances Rate Cuts in Higher Brackets**  
*Greater Percentage Rate Cuts Cause Bigger Dollar Benefits at Higher Incomes*

Income Bracket	Current Law Tax Rate	House Ways & Means Proposed Rate		New Proposal		Rate Cut from House W&M to final
		Rate	% Rate Cut	Rate	% Rate Cut	
\$0 to \$1,628	0.36%	0.34%	5.6%	0.33%	8.3%	2.9%
\$1,629 to \$3,256	0.72%	0.68%	5.6%	0.67%	6.9%	1.5%
\$3,257 to \$6,512	2.43%	2.31%	4.9%	2.25%	7.4%	2.6%
\$6,513 to \$14,652	4.50%	4.28%	4.9%	4.14%	8.0%	3.3%
\$14,653 to \$24,240	6.12%	5.94%	2.9%	5.63%	8.0%	5.2%
\$24,241 to \$32,560	6.48%	6.29%	2.9%	5.96%	8.0%	5.2%
\$32,561 to \$48,880	6.80%	6.60%	2.9%	6.25%	8.1%	5.3%
\$48,881 to \$73,260	7.92%	7.84%	1.0%	7.44%	6.1%	5.1%
Over \$73,260	8.98%	8.89%	1.0%	8.53%	5.0%	4.0%

Source: Department of Revenue

**Special ‘Pass-through’ Tax Break for Qualified Business Income**

The federal government established a new tax provision for “pass through” business income claimed on the individual income tax, the qualified business income deduction (QBID). This provision was very controversial at the federal level, and the rationale for its application at the federal level (to level the tax rates between individual and corporate income taxes on business income) does not hold at the Iowa income tax level. The provision is heavily skewed toward very high income individuals.

Both the Governor’s proposal and the House Ways and Means bill included a state QBID — at one-quarter of the federal level. The new proposal, however, triples that amount by tax year 2022. The cost of this tripling — 60 percent of which goes to the top 2 percent of Iowa tax filers (incomes over \$200,000) or nonresident tax filers (with average incomes over \$470,000) — is over \$65 million in tax cuts annually.

**Cost and Overall Impact of the Tax Proposals**

There are two calculations that have been used in the tax discussion to assess the impact of tax changes on the General Fund. Because Iowa law allows for federal deductibility and the federal tax cuts reduce the amount taxpayers will have to deduct, Iowa revenue would go up if the state takes no action to change taxes. Iowa’s tax revenue also increases with growth in state population and income. Many lawmakers have committed to lowering state taxes to avoid a net boost to the state from the federal tax changes, although others have argued for using that funding to restore budget cuts that have occurred.

It is important to note, however, that over the next four years, the Department of Revenue projects that the increase of revenue from the federal law is \$760 million. All three proposals produce overall tax cuts that are larger than this level, about \$20 million for the Governor’s proposal over the next four years and \$110 million for the House Ways and Means Committee proposal. The new proposal, however, reduces revenues \$660 million below what it would have been before the federal law, with normal revenue growth generally considered as necessary to sustain current expenditures.

**Impact of Tax Cuts**

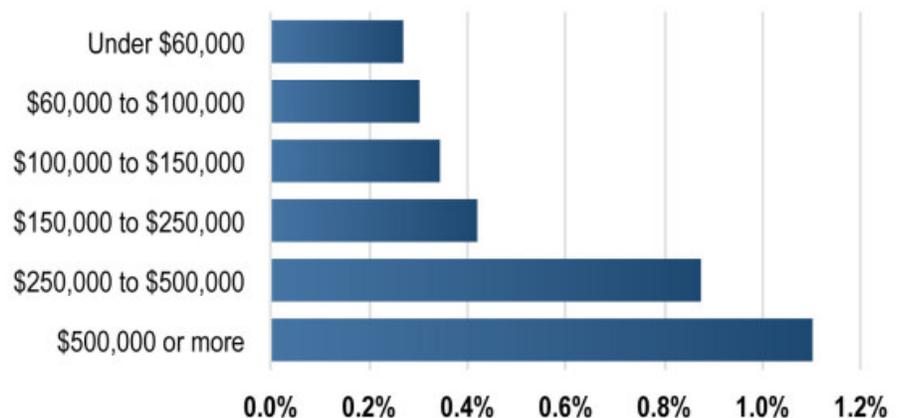
In addition to providing information on the overall tax impacts of tax proposals, the Department of Revenue provides information on the distribution of tax by income levels. The Institute on Economic and Tax Policy provides estimates of the sales tax impact by income level and, since all three proposals include sales tax modernization that taxes additional remote and e-commerce sales, the net effect of the tax bill for

**Little for the middle class: Bulk of tax benefits to the wealthiest**

*Average tax cuts, percent of total cuts by income, 2021*

Adjusted Gross Income	Percent of Taxpayers	Average Tax Cut	Percent Reduction	Percent of Total Tax Cut	Tax Cut: Percent of Income
Under \$20,000	28.3%	\$ (8)	0.0%	0.8%	-0.31%
\$20,000 to \$60,000	36.8%	\$ (100)	-8.8%	12.2%	-0.27%
\$60,000 to \$100,000	17.1%	\$ (232)	-7.5%	13.2%	-0.30%
\$100,000 to \$250,000	15.4%	\$ (534)	-8.2%	27.3%	-0.38%
\$250,000 to \$1 million	2.3%	\$ (4,014)	-17.5%	30.4%	-1.00%
\$1,000,000 or more	0.2%	\$ (24,636)	-19.4%	16.1%	-1.01%
Total	100%	\$ (300)	-11.1%	100.0%	-0.48%

*Tax cut in 2021 as percent of income, by Adjusted Gross Income*



Source: Iowa Department of Revenue, Table 9A, letter to Legislative Services Agency, May 2, 2018

individuals is what they receive in tax changes (generally reductions) from the income tax changes and what they may pay in additional sales taxes.

For the next four tax years the bulk of the tax savings go to the most well off. In 2021, almost half of the tax cuts will go to the richest 2.5 percent of Iowa taxpayers, those making \$250,000 or more. Their taxes are reduced by 18 percent, over twice the cut for those in the middle. For those making over a million dollars, the tax cut will average \$24,636. **Meanwhile, those in the middle will see income tax cuts of \$100 to \$300 over the next four years, much of which will be taken back in increased sales taxes of \$35 to \$60.**

That combination of income tax cuts (on average) with increases in sales taxes will, at lower and middle-income levels, will wipe out all or most of income-tax cuts received in 2021.

The expansion of the standard deduction in the Governor's proposal and the original HF2489 result in a small reduction in per filer taxes paid by the lowest-income tax filers, but the new proposal has no standard deduction and does not provide any such gain.

All three proposals provide the largest benefits, in both per filer dollar terms and a percent of income terms, to those filers at the highest income level, over \$250,000, but these are largest for the new proposal. The reason behind the very disproportionate share of the reductions going to those at the top income levels are not due just to rates but to are the result of other provisions, such as the QBID, discussed earlier, and the 179 expensing provisions, as well.

### ***Impact on the Iowa Economy***

**Finally, history in Iowa and other states offers a gloomy forecast for the economic impact of such tax cuts and the service cuts to follow.** As we have reported elsewhere, the last major income tax cuts in Iowa, in 1997-98, not only failed to stimulate growth, but likely contributed to the subsequent slowing of the state's economy.<sup>2</sup> The tax cuts in Kansas led to slower growth.<sup>3</sup>

### ***A Note on the Changes in the FY2023 Tax Year***

The new proposal provides for the changes described above for the first four fiscal years, but for 2023 it offers a very different proposal for the individual income tax — one that eliminates federal deductibility, further expands the QBID, eliminates the minimum tax, lowers overall rates, and adopts federal definitions of taxable income (in effect adopting the federal standard deductions).

This revision, however, is only triggered if revenue growth exceeds a certain, highly unlikely amount. It also is subject to at least four years of further legislative examination before becoming law — and if implemented would involve substantially more revenue reductions. Their promise of large reductions for moderate and middle-income tax filers (because of the standard deduction increases) is contingent upon a number of factors and quite far in the future. Thus our discussion here focuses on the impacts that would happen in the near term.

***Charles Bruner is a former state senator and former executive director of the Child and Family Policy Center (CFPC). Peter Fisher is research director of the Iowa Policy Project (IPP) and the Iowa Fiscal Partnership, which is a joint public policy initiative of CFPC and IPP.***

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<sup>1</sup> Peter Fisher, "House tax bill backs wealthy," Iowa Policy Points blog, April 26, 2018. <https://iowapolicypoints.org/2018/04/26/house-tax-bill-backs-wealthy/>

<sup>2</sup> Peter Fisher, "Tax cuts: Already tried, failed," Iowa Policy Points blog, April 23, 2018. <https://iowapolicypoints.org/2018/04/23/tax-cuts-already-tried-failed/>

<sup>3</sup> Peter Fisher, "The Lessons of Kansas," GradingStates.org, 2017. <http://www.gradingstates.org/the-problem-with-tax-cutting-as-economic-policy/the-lessons-of-kansas/>