Iowa Fiscal Partnership

BACKGROUNDER

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Beyond 2010, Tax Reform Would Continue Benefits

Individuals, Small Businesses Would See Similar Effects in 2011-13

Much of the discussion over current proposals to reform Iowa's income tax system by removing federal deductibility and lowering rates for all brackets has focused on the proposal's effects in 2010. The Department of Revenue (DOR) also has estimated the impacts of the proposal in 2011-13.

Official estimates: Substantial share would keep benefits

The DOR estimates show that reforms would continue to benefit a substantial share of Iowa taxpayers, including small-business owners, during these years. These estimates also show the overall incidence of the income tax does not change significantly over this period under the tax proposal. In other words:

- The DOR estimates are based on assumptions about economic growth, which would mean an increase in overall state income-tax collections in 2011-13, ***however:***
- The relative share collected from taxpayers at different income levels remains the same.

The Department of Revenue's analysis uses current federal and state tax law as a baseline for estimating the changes that different groups of taxpayers will see as a result of this income-tax reform proposal and for estimating the amount of revenue that will be collected. Since current tax law includes federal deductibility, which links Iowa tax collections to federal tax law, these estimates must make assumptions about what changes will occur in federal income taxes. Because they simply use current law as the baseline, DOR estimates assume that all the tax cuts enacted under the Bush administration in 2001 and 2003 will expire on schedule in 2011, raising federal taxes on upper- and middle-income earners. This is understandable for DOR's analysis, but it is a weakness.

Uncorrectable flaw in DOR assumptions — many federal tax cuts won't expire

The problem with the assumptions that DOR must use — that federal tax law will remain as it is — is that it ***is highly unlikely that federal tax cuts on middle-income earners*** (those earning less than $250,000 a year) ***will be allowed to expire in 2011.*** President Obama's budget, sent to Congress in February, proposes that the middle-class tax cuts enacted in 2001 and 2003 (including a $1,000 child credit, lower rates, and provisions to address the "marriage tax penalty") be made permanent, rather than being allowed to expire at the end of 2010.[1] The President's budget does propose allowing some tax cuts to expire as scheduled in 2011, but only tax cuts for taxpayers making more than $250,000 a year.[2]

According to Department of Revenue assumptions, the expiration of all federal tax cuts would mean that Iowa income-tax collections would drop dramatically between 2010 and 2011, assuming no changes to current law at the state or federal level. This drop in state tax collections — compared with the revenue collections under the proposed change — is approximately $150 million. ***However, if the President's recommendations pass, including continued middle-class tax cuts, and if state income-tax reform goes ahead, then state tax collections would be affected much differently from DOR assumptions.***

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Other important notes on official assumptions

- Almost half of DOR's assumed increase in tax liability in 2011-13 is attributed to increases for taxpayers with incomes below $250,000, where federal tax law is unlikely to change as assumed.
- As a result, the percentage of Iowa taxpayers benefiting under the proposed changes to state income-tax law will likely be very similar to that identified for 2010 – in which 60.4 percent would see a tax reduction and 26.9 percent would see a tax increase compared to current tax law.
- Some of the increase in overall tax liability from year to year that is reflected in the DOR model is due to assumptions about increases in aggregate income that will occur as the economy grows. The extent to which incomes will actually grow over the next four years depends on how quickly Iowa's economy begins to recover and pull out of recession. If the current economic climate continues, incomes may not grow as quickly as DOR's analysis assumes.
- Finally, it is important to note that projected increases in tax liability are aggregate estimates. An individual family making the same income in 2011 that it made in 2012 will actually pay less income tax because tax brackets are indexed to inflation and move up every year. In other words, there is no "tax increase" built into the proposed legislation, although the aggregate amount of income tax collected will grow if the economy grows or if inflation increases.

Like other Iowa taxpayers, small businesses benefit in 2011-13

The Department of Revenue produced estimates of how Iowans with small business income, filing a Schedule C, E or F return, would be affected by the income tax reform proposal now under consideration in 2010. Based on what we know about the incomes of small business owners in Iowa and the likely changes to federal tax law described above, ***it is clear that Iowa small business owners also continue to benefit from income tax reform in 2011-13***. Why?

- ***First, federal tax law changes in 2011 will likely affect only Iowans earning more than $250,000.***

Very few small-business owners in Iowa fall into this category. According to the Department of Revenue, only 2.7 percent of Iowa taxpayers filing a Schedule C (business income) return had an Adjusted Gross Income (AGI) above $250,000. Only 5.8 percent of Schedule E filers (partnership, LLC, S-Corps, rent, royalty, and trust income) and 1.8 percent of Schedule F filers (farm income) had AGIs exceeding $250,000.

- ***Second, the share of taxpayers with small-business income benefiting or seeing no change from the income-tax reform plan is quite similar to the general population of taxpayers (actually a little larger than the general population).***

Thus, we would expect small-business owners to be treated similarly to all taxpayers in 2011-13. ***This means a majority of small-business owners would continue to benefit or see no change*** in their income taxes as a result of the proposal under consideration to combine cuts in all tax rates with elimination of federal deductibility.

Conclusion

Complex links between state and federal tax law illustrate the potential danger to state fiscal stability of federal deductibility, which ties Iowa tax law to federal changes. Such a provision adds uncertainty to the state income-tax base, which can change due to factors outside the state's control. Maintaining a stable and sustainable tax base is a widely recognized principle of sound taxation policy. Nearly every state has moved away from federal deductibility because of the instability it brings to a state tax system.

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[1] Horney, James. *An Analysis of the House and Senate Budget Plans*. Center on Budget and Policy Priorities. April 1, 2009. Available from: http://www.cbpp.org/cms/index.cfm?fa=view&id=2757. See also Urban-Brookings Tax Policy Center. Tax Proposals in the 2010 Budget. March 2009, p. 25. Available from: http://www.taxpolicycenter.org/UploadedPDF/411849_2010_budget.pdf.

[2] For analysis on this point, see testimony of Robert Greenstein, Executive Director, Center on Budget and Policy Priorities. Senate Committee on Finance. March 26, 2009. Available from: http://www.cbpp.org/files/3-26-09bud-testimony.pdf.