



Iowa Tax Reform: Some Ideas Have Merit, But. . .

by David Hogberg

Last December many legislative leaders proposed various reforms to Iowa's tax system. Some of the proposals have the potential to be serious reforms that would reduce Iowa's tax burden. However, some adjustments must be made, or the reforms would actually raise taxes.

State Senator Larry McKibben has advanced the idea with the most promise. According to *Des Moines Register* columnist David Yepsen, McKibben suggests "eliminating many of the income-tax deductions and credits Iowans enjoy in favor of giving them a much simpler tax system and a much lower income-tax rate, probably about 3.5 percent."¹ In other words, State Senator McKibben is proposing a flat tax. This would greatly simplify Iowa's income tax system, which currently has nine rates. As such it has the potential to be a pro-growth tax reform.

I say "potential" depending on what is meant by "eliminating many of the income-tax deductions." If that means eliminating Iowans' ability to deduct their federal income taxes on their state income tax returns, then the reform would result in an actual tax increase for those Iowans earning over \$100,000 annually. For those earners, eliminating the federal deduction and imposing a 3.5% flat tax would result in an average increase of \$3,400 per taxpayer.² This would no doubt play well with the tax-the-rich, class-warfare crowd, but it would have a dampening effect on wealth creation in the state of Iowa. The wealthy are also wealth-producers. Increasing taxes on the wealthy diminishes their incentive to invest and expand businesses, activities that create jobs for Iowans. To avoid raising taxes on wealth producers, State Senator McKibben should keep the federal deduction.

Indeed, elimination of the federal deduction is a reform fraught with peril. Yepsen states that eliminating the deduction would be joined with a "lowering [of] income-tax rates." Yet, as Yepsen notes, "Many conservatives are rightly concerned that liberal spenders would eliminate the deduction without lowering rates much, thereby creating a back-door tax increase."³ That is a very reasonable fear. To see this, consider that an elimination of the deduction with no corresponding reduction in tax rates would amount to a 20% increase in Iowa income taxes.⁴ Thus, it is quite possible that a reduction in rates coupled with the elimination of the federal deduction might still result in a modest across-the-board increase. Even a relatively small increase like 5% could have serious economic consequences. According to a dynamic analysis I conducted, a 5% increase in income taxes would reduce personal income growth in 2003 by over \$415 million. Ultimately, Legislators should not tamper with the federal deduction.

In fact, to make a flat tax work, it requires more than just maintaining federal deductibility. It must be coupled with an Amendment to the State Constitution. This Amendment would mandate that Iowa would have no more than one income tax rate and require a 60% vote of the Legislature before it could be raised. This is necessary to prevent future mischief from tax-hungry politicians.

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Another idea that should be given careful consideration is State Senator Stewart Iverson's reduction of the state sales tax from 5% to 3%. To maintain the same amount of revenue coming into the state, State Senator Iverson would eliminate all of the sales tax exemptions, including those for food and medicine. Yet such a reform would not be revenue-neutral. In 2000, the most recent year for which data is available, sales in the state of Iowa totaled about \$51.005 billion.⁵ At a rate of 3%, Iowans would have paid about \$1.53 billion in sales taxes in 2000. That is about \$145 million more than the \$1.385 billion they actually did pay. During this time of a sluggish Iowa economy, lawmakers should not be increasing the tax burden on Iowa consumers.

It is also questionable whether eliminating the exemption for necessities like food and medicine is desirable. A better reform would be to eliminate all the exemptions *except* the ones for food and medicine, and then reduce the rate from 5% to 3.25%. Based on the 2000 numbers, a 3.25% rate would have reduced the tax burden for the average Iowan while yielding slightly less sales tax revenue for the state.

Some of the tax-reform ideas being considered by State Legislators could reduce Iowa's tax burden and make Iowa much more tax-competitive relative to other states. They should proceed with these ideas. But they should do so carefully so that the reforms do not inadvertently become tax increases.

ENDNOTES:

¹David Yepsen. "Add Numbers, Rewrite Law: Iowa Could Drop to 3.5% Income Tax," *Des Moines Register*, December 5, 2002, <<http://desmoinesregister.com/opinion/stories/c5917686/19838941.html>> (December 5, 2002).

²Numbers based on Iowa Department of Revenue and Finance, "Iowa Individual Income Tax Annual Statistical Report, 2000," pp.22-23, n.d., <<http://www.state.ia.us/tax/educate/00inprep.pdf>> (December 9, 2002).

³David Yepsen. "Add Numbers, Rewrite Law: Iowa Could Drop to 3.5% Income Tax," *Des Moines Register*, December 5, 2002, <<http://desmoinesregister.com/opinion/stories/c5917686/19838941.html>> (December 5, 2002).

⁴Numbers based on Iowa Department of Revenue and Finance, "Iowa Individual Income Tax Annual Statistical Report, 2000," pp.22-23, n.d., <<http://www.state.ia.us/tax/educate/00inprep.pdf>> (December 9, 2002).

⁵Data on Iowa sales estimated from sales tax data provided by the Iowa Department of Revenue and Finance, and from sales tax exemption data from the Iowa Department of Revenue and Finance "Iowa Tax Expenditures 2000," July 2001, <<http://www.state.ia.us/tax/taxlaw/taxexp01.pdf>> (November 4, 2002).

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