ISSUE REVIEW

Iowa Legislative Fiscal Bureau

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Review of Tax Study Results

ISSUE

On August 11, 1996, the Des Moines Register reported the results of a tax study the newspaper commissioned from KPMG Peat Marwick. The article reported comparisons between Iowa and 15 other states of state income tax liability for five hypothetical families. This ***Issue Review*** examines the results of the study as it was printed in the Register. **Appendix A** provides a copy of the article, as printed in the Des Moines Register.

BACKGROUND

The Register described the five families as follows. Iowa tax liability and rank among the 16 states, as reported by the Register, are shown in parenthesis. A rank of "1" indicates the highest tax among the 16 states.

- A single parent with one-child earning $20,000 ($720, rank 4).
- A single person earning $25,000 ($1,118, rank 5).
- A two-income, two-child couple earning $45,000 ($1,774, rank 4).
- A two-income, two-child couple earning $120,000 ($6,921, rank 3).
- A two-income, two-child couple earning $400,000 ($24,449, rank 7).

Although the Legislative Fiscal Bureau (LFB) was denied a copy of the study from the Des Moines Register, a Peat Marwick representative did respond to specific inquiries that arose during the development of the LFB analysis. The representative confirmed the following LFB observations regarding the Peat Marwick analysis:

- Couples in the study elected to file "married filing joint return" (status 2), rather than "married filing separately on a combined return" (status 3). Status 3 is commonly referred to as "income-splitting." Thus, although the Register described "two-income" couples, the study did not utilize income-splitting where applicable.
- The Peat Marwick tax calculations did not include the Earned Income Tax Credit where applicable.

- The Peat Marwick tax calculations did not include the Child and Dependent Care Credit where applicable.
- The Peat Marwick tax calculations did not consider other credits or deductions that may uniquely affect the results for some states but not others. For example, some states (not Iowa) allow a renters credit that can be applied against income tax liability.

LEGISLATIVE FISCAL BUREAU APPROACH

In each case, the LFB determined a reasonable set of assumptions required to arrive at the Peat Marwick estimate of income tax liability (a detail of the methodology is provided on page 5 of this ***Issue Review***). The following factors were considered in our analysis: type of deduction, amount of deduction, eligibility for Earned Income Tax Credit, eligibility for Child and Dependent Care Credit, use of "income splitting" for married filers, amount of income received "pre-tax", number of personal exemption credits, federal income tax liability (assuming each family paid exactly what was owed in the tax year for which the liability was incurred).

The LFB did not analyze the methodology of the study as applied to the other 15 states. As noted above, some states have deductions or credits that may be unique to those states.

RESULTS

Single parent with one child earning $20,000 - The Register article reported an expected tax liability of $720. The LFB analysis suggests a typical tax liability of approximately $385. To match the Register's number, we would have to assume: the taxpayer had no child care expenses; the taxpayer did not receive any pre-tax earnings1; and the taxpayer received a federal income tax refund (of 1994 taxes) of approximately $867 in 1995.

This is the only scenario that was not reasonably replicable. The $720 tax bill reported in the Register did not take into account the Earned Income Tax Credit at either the federal or State level and assumed the single parent would have no child-care expenses, and would therefore be ineligible for the Child and Dependent Care Credit.

The figure also assumes the taxpayer would have no pre-tax income, like health insurance or 401K contributions. Even putting the taxpayer in this unusual set of circumstances, tax liability in tax year 1995 would not have reached $720, unless the taxpayer received a substantial tax refund from the prior year.

If the entire $20,000 were earned income (e.g. not welfare or interest income), and the taxpayer had no child care expenses, the tax liability would have been approximately $660. Failure to take into account the Earned Income Tax Credit does not significantly impact Iowa tax burden, however, because the increased tax (due to lower deduction for taxes paid) almost exactly offsets the decreased tax (due to Iowa's 6.5% of the federal credit). If the taxpayer claimed $2,400 of child care expenses, State tax liability would decrease to $387; 46.2% less than the amount reported in the Register.[2]

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[1] From the Des Moines Register article, it is not possible to determine with certainty that pre-tax earnings were not considered. It is conceivable that the incomes reported for each family had already been reduced by a specified pre-tax earnings amount.

[2] If the study had assumed the person earned $19,999 rather than $20,000, the tax liability would have been $315 rather than $387, due to the phase-out schedule for the various tax credits.

Single person earning $25,000 **-** *The Register article reported an expected tax liability of $1,118. The LFB analysis suggests a typical tax liability of approximately $1,100. To match the Register's number, we would have to assume: the taxpayer took the standard deduction at the State and federal level; and the taxpayer did not have any pre-tax earnings.*

This scenario is a straightforward calculation, and there do not seem to be any problems with the Peat Marwick estimate. Based on tax year 1995 data, the individual's expected tax liability would have been approximately $1,100, assuming the individual paid exactly the amount of tax owed in the prior tax year. In any case, the $18.00 difference in estimates does not change Iowa's rank among the 16 states.

Two-income couple, two children, earning $45,000 **-** *The Register article reported an expected tax liability of $1,774. The LFB analysis suggests a typical tax liability of an amount between $500 and $1,775. To match the Register's number, we assume: the couple filed "married-joint" rather than "combined-separate"; the couple claimed $12,229 in federal itemized deductions; the couple had no pre-tax earnings.*

If the couple chose to file "married-joint" (typically done only if one parent earned all of the income), and the couple declared slightly above average itemized deductions for this classification, the family's State tax liability would have been approximately $1,774, the amount determined by Peat Marwick. Thus, it appears that what the Des Moines Register reported as a "two-income couple" can be more accurately labeled a "one-income couple". The dramatic difference in tax liability is due to a unique feature of the Iowa tax system called "income-splitting", or "combined-separate" reporting. This feature allows the income of the second wage earner to be taxed at lower rates. Of the 16 states in the study, only Iowa and Missouri have this feature.

The tax liability for this family as reported in the Register could also be matched if both parents earned $22,500 each; the couple chose not to itemize deductions; had no child-care expenses; and if the couple received approximately 3.0% of their income pre-tax. Under these conditions, the State tax liability would have been approximately $1,775.

However, more than half of all taxpayers in this income classification itemize deductions, which affects State tax liability much more than federal tax liability. If this same couple claimed a federal itemized deduction of $11,097 their tax liability would drop to approximately $640; 63.9% less than the tax reported in the Register.[3]

Two-income couple, two children, earning $120,000 **-** *The Register article reported an expected tax liability of $6,921. The LFB analysis suggests a typical tax liability of an amount between $4,200 and $5,020. To match the Register's number, we assume: the couple filed "married-joint" rather than "combined-separate"; the couple claimed $22,702 in federal itemized deductions; the couple had no pre-tax earnings.*

The issue of income-splitting is important for this family as well. We were able to replicate the Register's estimate of $6,921 by assuming that total itemized federal deductions were approximately $22,700, which is comparable to the average for this group. As with the previous scenario, we also have to assume that one parent earns the entire $120,000, and the other parent has no income. If, on the other hand, the family were comprised of two parents each earning $60,000, the tax liability would have declined to slightly less than $4,200, a reduction of nearly

[3] Itemized deductions are $1,132 less for the family filing "combined-separate" because an assumption was made that the family would spend their tax savings on non-deductible items; tax liability would be even lower if the savings were spent on tax deductible items. A description of this effect is provided in the final section of this ***Issue Review.***

40.0% (assuming the couple spent their tax savings on non-deductible items). Similarly, if one spouse earned $90,000 and the other earned $30,000, the combined tax liability would have been approximately $5,020.

Two-income couple, two children, earning $400,000. *The Register article reported an expected tax liability of $24,449. The LFB analysis suggests a typical tax liability of an amount between $18,730 and $24,500. To match the Register's number, we assume: the couple filed "married-joint" rather than "combined-separate"; the couple claimed $56,033 in federal itemized deductions; the couple had no pre-tax earnings; the couple had no long-term capital gains.*

At this level of income, the effect of income-splitting becomes less important due to the fact that such a large proportion of the income is in the top State income tax bracket. We were able to replicate the results of the study, but the variation in tax liability for this family type is arguably much larger between individual taxpayers than it is between similar taxpayers in different states.

CONCLUSIONS

Without the actual study, it is difficult to fully assess the methodology or conclusions of the Peat Marwick cross-state comparison. Nonetheless, the results of this analysis suggest the need to take into account the effect of the Earned Income Tax Credit and Child and Dependent Care Credit in the case of low-income taxpayers; and the effect of income-splitting in the case of middle and upper income taxpayers. Also, because the study assumed zero pre-tax income (income used to purchase health insurance, pensions, or various flexible spending accounts), the tax liability for all 13 states (including Iowa) with an income tax is probably exaggerated.

In addition to Iowa, only Minnesota and Wisconsin allow an Earned Income Tax Credit, indicating that reported tax liability for these states is artificially high. The Child and Dependent Care Credit is somewhat more common, available in six of the 16 states including Iowa, but the amount allowed in Iowa exceeds all but a few states in the nation.

The issue of income-splitting should have been addressed for two reasons. Initially, as of tax year 1994, of the 16 states reviewed, only Missouri and Iowa allow income-splitting. The fact that the Peat Marwick study addressed only single-income couples magnifies the problem. This is especially true for the two-income couple earning $120,000, for which only one parent was earning income. Of the 27,000 couples in Iowa earning more than $100,000, 22,400 (83.0%) utilize the income-splitting feature of the State tax system.

Assuming there are not peculiar properties to the other state tax systems, Iowa's rank for four of the five families would improve. The following chart shows Peat Marwick's ranks as reported in the Des Moines Register and ranks assuming the use of the Iowa Earned Income Tax Credit, and the Iowa Child and Dependent Care Credit. The table includes a range of ranks determined by the LFB. The first assumes equal income-splitting for the three families with two-incomes. The last set of ranks assume a one parent earns 75.0% of the family income. The ranks also assume that the two-income families take average itemized deductions.	Two-income; Two Children; $400,000	Two-income; Two Children; $120,000	Two-income; Two Children; $45,000	Single Person; $25,000	Single Parent, One child; $20,000
Peat Marwick Iowa Ranks	7	3	4	5	4
Iowa Ranks Adjusted for Listed Factors (equal income-splitting)	10	11	12	5	11
Iowa Ranks Adjusted for Listed Factors (income split 75/25))	8	11	9	5	11
1 = Highest Tax State of 16 Surveyed					
16 = Lowest Tax State of 16 Surveyed					

It should also be noted that Iowa's adjusted ranks may be lowered due to the fact that some states allow the factors addressed in this analysis. Specifically, Wisconsin and Minnesota offer Earned Income Tax Credits that are more valuable to recipients than is the case in Iowa. Still, Iowa is the only state among the 16 selected that have all three properties in place: income-splitting, Earned Income Tax Credit, and Child and Dependent Care Credit. Additionally, the Legislative Fiscal Bureau did not address the issue of which states should be included in a cross-state comparison analysis. Specifically, it should be pointed out that, although Iowa has an adjusted rank of 11 out of the 16 states in the survey for the two-income couple earning $120,000, the rank would be 11 out of 13 if the states with no state income tax were omitted from the study.

EXPLANATION OF METHODOLOGY

In general, the Register's reported tax liabilities for each family and each family's state income were starting points. Then an iterative process was used to determine possible values of itemized deductions and federal tax liability that would result in the pre-determined tax liability.

Type of Deduction

This analysis assumed the three highest income families would itemize deductions, whereas the single person and single parent would take the standard deduction.

Filing Status

The single parent filed "head of household" and the single person filed "single." The LFB initially tried to impose a constraint that the three highest income families split income equally and filed "combined-separate." However, the result was not plausible (the family would have to claim negative itemized deductions). A representative from Peat Marwick was contacted and explained their calculations were based on the assumption that the couples filed "married-joint." At that point, it was possible to determine the itemized deductions required to arrive at the stated income tax liability for each family.

Once the itemized deductions were determined, we were able to change the filing status of each couple to "married-combined" making various assumptions with respect to the percentage of family income earned by each parent. The resulting tax savings, however, would be subject to federal income tax, unless the couple spent the entire amount on tax deductible items, such as charitable contributions. Using an iterative process, we imposed the constraint that the entire savings would be taxable, which resulted in decreased federal itemized deductions.

Other Assumptions

In all cases, we assumed that the taxpayers had withholding (or estimate payments) exactly equal to tax liability. This condition also applied to tax year 1994, such that the taxpayers paid no 1994 taxes (received no 1994 refunds) in 1995.

In the case of the single parent, we assumed the taxpayer incurred $2,400 in child care expense (the maximum for the federal Child and Dependent Care Credit); and the taxpayer received the Earned Income Tax Credit.

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Iowa tax bite is among the biggest

The state fares poorly in a study of income tax bills — but is a cut in order?

By DAVID YEPSEN
REGISTER STAFF WRITER

Iowans' state income tax bills are among the highest in the country, according to a study done for the Des Moines Sunday Register by a leading national accounting firm.

Middle- and lower-income taxpayers have some of the highest tax bills in the state, the study shows. And in some cases, these taxpayers are paying more than similar residents of Massachusetts or California, states with reputations for high taxes.

The lofty taxes also may be discouraging investment and development in Iowa, one of the experts who did the study said.

The study was done by the accounting and business consulting firm of KPMG Peat Marwick. At The Register's request, the firm calculated 1996 income tax bills for five types of taxpayers. The firm did the study at its own expense.

"The big picture is, we're on the high side," said Suku Radia, a managing partner for the firm who supervised the study. "We're in the upper quarter."

Iowa's income tax "is like a Kmart special," Radia said. "It really stands out."

Gov. Terry Branstad said the study underscores the need for the Legislature to approve state income tax cuts he will seek in 1997.

Other experts said Iowa should go slowly as it cuts income taxes. The money they bring in pays for good public services, the experts said. But they also acknowledged that the state needs to worry about being competitive.

The study examined the state income tax bills for five hypothetical types of taxpayers in 16 states:

- A two-income, two-child couple earning $400,000. While there are few people earning that kind of money in Iowa, those are the types of business executives and entrepreneurs the state wants to attract and keep.
- A two-income, two-child couple earning $120,000 with two children. Many professional couples fit this category.
- A two-income, two-child couple

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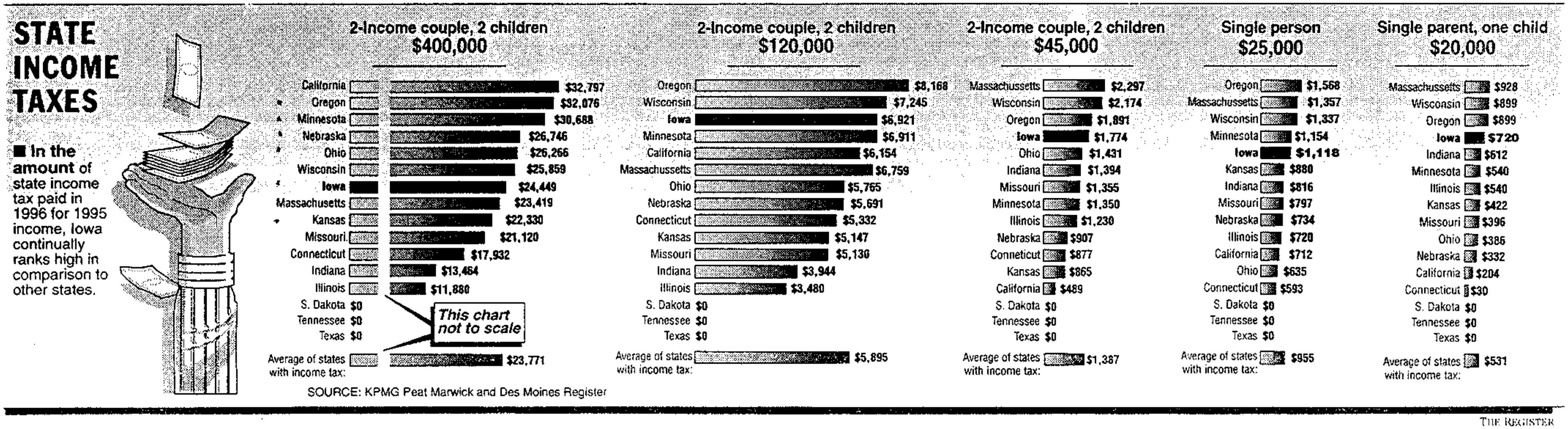

Iowa income tax bite among nation's biggest, study finds

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earning $45,000. Many blue-collar families resemble this example.

- A single person earning $25,000.
- A single parent with one child and $20,000 in income.

The states selected for comparison are those bordering Iowa, other Midwestern states, and states identified by the Greater Des Moines Chamber of Commerce as ones that are Iowa's leading competitors for economic development.

Peat Marwick manager Matt Juffer calculated 65 different tax returns — one for each of the five types of taxpayers in 13 of the 16 states. (Three states listed by the chamber as competitors with Iowa are South Dakota, Texas and Tennessee — states that have no income tax.)

Better Comparison

Juffer said the firm's computer programs take into account the nuances of every state's income tax laws. Because the programs make allowances for deductions, they provide a better comparison than raw tax rates. For example, Iowa allows residents to deduct the federal taxes they pay before calculating their state income tax. Not all states allow that.

The firm used Internal Revenue Service assumptions for average deductions claimed by taxpayers in each income group. The study did not examine property or sales taxes paid, just the income tax bills.

"Out of 16 states, only three or four are higher," Radia said. "If we included the rest of the country, I don't think the results would change. We'll still end up in the upper quartile."

The findings confirm older studies. Census Bureau figures ranked Iowa 35th in per capita income in 1993, but 11th highest in individual income tax burden.

Lawmakers Mull Issue

Statehouse policy-makers have spent the last few years focusing on reducing property tax burdens. But now it could be the income tax's turn, said Drake University economist David Lawrence, a member of the Iowa Economic Forecasting Council.

"I think it's time to cut income taxes," he said. "It would be sound," and, with reserves and emergency funds of about $650 million, "it appears the surpluses are healthy."

The state's income taxes are high, Lawrence said. Even when the total burden of sales, income and property taxes are figured in, "it still appears the rates here are way above average," he said.

Branstad said the Peat Marwick examples were conservative because four compared two-earner couples. Families with one breadwinner pay a higher income tax than those with two.

"If you only had one wage-earner making this income, it would be worse," he said. "You're not looking at the worst case."

Housing Costs

Radia said areas of Iowa often are "compared to a Kansas City or St. Louis or an Omaha, and we are deemed to be more expensive." Housing also is relatively expensive in much of Iowa, he said.

"It just adds up," Radia said. When he talks to outsiders about locating in Iowa, "our high income tax has been thrown back to me several times."

Times are good, so the state can afford to cut income taxes, Radia and Branstad agreed. But other experts aren't so sure.

Recent studies say Iowa's income tax laws place an unfair burden on lower-income taxpayers. The Peat Marwick study confirms that.

Iowa State University economist Neil Harl said it's important for Iowa to invest in the things that make this a desirable place in which to live. He urged caution in cutting income taxes.

"I'm tending to believe the state has a lot of needs that are crying out for funding — schools and public buildings and prisons and bridges. We really need to utilize our fiscal gains in times like this to be sure our infrastructure house is in order and is well-maintained," he said. For example, states with high tax burdens often have attractive public amenities, such as recreation and education, that make them desirable places to live.

Competition

But Harl acknowledged that it's also important for Iowa to be competitive with other states for job growth and development. If business leaders think Iowa's taxes are too high, then the state has a problem. "Perception is what's important here," Harl said.

"If there are to be changes, then it should be toward moving us toward the middle of the pack" of income tax burdens, he added.

Radia agreed. "I'd sure like to find us someplace in the middle of the pack as opposed to being in the top quartile," he said. Branstad said Iowa's income tax bills should be below average.

But if it is desirable to cut income taxes, Iowa's policy-makers will have to decide who should get relief. It would take a 2.8 percent cut to bring taxpayers earning $400,000 to the average of the 13 comparison states. It would take a 26 percent cut to bring a single parent earning $20,000 in line with the comparison states.

The couple earning $120,000 would need a 14.8 percent income tax cut. For the couple earning $45,000, a 21.8 percent cut is in order. The single person earning $25,000 needs a 14.5 percent cut.

And that's just to be at the average among comparison states with income taxes. Those competing states that have no income tax weren't figured into the averages.

Gradual Change

Everyone needs tax relief, Branstad said, so an income tax cut should be across the board and spread over several years. A gradual reduction will show executives Iowa is trying to be competitive, but it would avoid the perils of a large one-time slash.

Statehouse progressives say an income tax cut should be directed more toward middle- and lower-income taxpayers. Recent studies by labor organizations and progressive tax groups say Iowa's income tax laws place an unfair burden on lower-income taxpayers. The Peat Marwick study confirms that.

They also argue it is more difficult for a single mother earning $20,000 to pay a $720 tax bill than it is for a couple pulling in $400,000 to pay a $24,449 tab.

Branstad said across-the-board relief will help everyone, even if it doesn't do anything to address inequities between classes of taxpayers.

Radia said there are other income tax changes Iowa needs to consider, such as tax simplification.

"Traditionally we have tried to couple with the federal tax law," he said. "But every single time, we find some way to make an exception for some group or the other, and the Iowa tax return has become very complicated for the average taxpayer."

He smiled: "As a CPA I shouldn't be saying that and promoting simplification, but in reality, as an average Iowa taxpayer, I'd sure like to see a simpler Iowa tax return."