A Preliminary Analysis of Shifting State Tax Policy in Iowa to Minimize Federal Income Tax Liability of Iowa Taxpayers

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A Preliminary Analysis of Shifting State Tax Policy in Iowa to Minimize Federal Income Tax Liability of Iowa Taxpayers

Abstract
Because of recent state budget deficit concerns, a study to examine innovative ways of reducing the state budget deficit by shifting state tax mix to minimize Federal Income Tax liability of Iowans was conceived on November 27, 1991. On the surface this concept appeared to have significant merit. In fact, several colleagues, policy analysts, economists, lawyers and interest group representatives, after hearing the concept indicated strong encouragement that the concept should be studied further.

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A Preliminary Analysis of
Shifting State Tax Policy in Iowa
to Minimize Federal Income Tax Liability
of Iowa Taxpayers. *

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Because of recent state budget deficit concerns, a study to examine innovative ways of reducing the state budget deficit by shifting state tax mix to minimize Federal Income Tax liability of Iowans was conceived on November 27, 1991. On the surface this concept appeared to have significant merit. In fact, several colleagues, policy analysts, economists, lawyers and interest group representatives, after hearing the concept indicated strong encouragement that the concept should be studied further.

Congress opened the door for this opportunity in the mid 1980's when sales taxes became no longer deductible on federal income tax returns. Many economists predicted that states would follow the federal incentives to move away from sales taxes to other federally deductible taxes. However, this was not the case due to the political environments within the states. Given the present changed political environment, perhaps the time is right to consider this option.

If Iowa could devise a way to shift the $1042 million (1) in 1993 estimated combined retail sales, retailers use, consumer use and motor vehicle use tax revenues which are not federally deductible to other state and local taxes like income, business activity, or property taxes that are federally deductible, then significant federal income tax savings would result. The state could then design a mechanism that recaptures part of the revenues and allow Iowan taxpayers to keep the rest. This approach would have the unique characteristic of reducing the Iowa deficit without cutting state spending or without increasing the overall tax burden of Iowans. In fact, the overall tax burden of Iowans would likely decline, helping to stimulate new economic growth.

Because there are many federally deductible taxes, several alternatives were suggested by colleagues and others. These ideas were developed in concept, so that an examination of the options would provide some basis for comparison. Here is a summary of the alternatives that are assessed in this report:

1. Replace sales tax with an equivalent federally deductible:
   a. Retail withholding and business activity tax adjustment (BAT).
   b. Retail withholding and business income tax adjustment, (RITA).
   d. Tax Rate Adjustment for Individuals, (TRA).
   e. Property Tax Adjustment (PTA).
In summary, it is concluded that three options are potentially economically and legally feasible in terms of generating federal income tax savings for Iowans. The preliminary analysis conducted indicates that the MITA, TRA, and PTA options could likely generate $75 to $175 million in federal income tax savings and additional indirect tax revenues. Depending upon the option, partial offsetting revenue losses, issues of tax equity, change in tax incidence, and administrative efficiency would need to be resolved. On the other hand, significant indirect benefits to the economy may also result. Therefore, the concept of minimizing federal income tax liability appears to be sound. However, additional study and more rigorous analysis using more sophisticated models is strongly recommended by policymakers and their analysts before such a plan is implemented.

ANALYSIS OF BUSINESS ACTIVITY AND RETAIL INCOME-TAX ADJUSTMENTS (BAT) and (RITA)

The concept is to replace 4 percent retail sales and use taxes with a 4 percent withholding on retail sales and a Business Activity Tax (BAT) or a Retail Income Tax Adjustment (RITA) assessed against the businesses that sell retail items. The assessment of tax would be changed from the individuals who purchase items to those who sell the items. Roughly the same total amount would be paid by the purchaser. However, instead of paying the price plus the tax, the purchaser would pay a price which includes an equivalent percentage of withholding.

The fallacy of this option is that presently the sales and use taxes are not figured into the gross income of retail businesses for tax purposes. As a result, the retail businesses would gain the $1.042 billion in additional federal income tax deductions, but they would also gain $1.042 billion of additional gross income. Therefore, their federal income tax liability would remain roughly the same as under the present system and no federal income tax savings would be generated.

ANALYSIS OF INDIVIDUAL INCOME TAX ADJUSTMENTS (MITA) AND (TRA)

The Minimum Income Tax Adjustment (MITA) would eliminate the statewide retail sales and use tax and then apply a minimum income tax adjustment to the bottom line of all individual income tax returns. The adjustment would be designed to mirror individual consumption and would be based on the number of exemptions. Technical definitions of the MITA would be adjusted enough to allow the MITA to be federally deductible.

The Tax Rate Adjustment (TRA) approach would be simpler to implement and administer than the MITA approach. The TRA would simply eliminate the statewide retail sales and use tax and then increase the legal marginal tax rates for each state income tax bracket by approximately 2 to 2.4 percent. Replacing the sales tax
by shifting all income tax rates upward by the same amount would tend to make Iowa’s tax system less regressive than it now is. Income groups less than $75,000 would experience the same or lower overall tax burden.

If both approaches were designed to raise $1.042 billion in state revenues, which is equivalent to 1993 state sales and use tax collections, about $147.3 million in federal income tax savings would be generated for Iowans, based on a marginal effective tax rate of 14.1 percent. (1) 

A potential offsetting factor is the amount of 1993 retail sales and use taxes that are paid by non-residents. An educated guess is that non residents might pay 5 percent of the present sales and use tax. Translated into 1993 sales and use tax revenues this would have been $52.1 million. Under the MITA or TRA approach, non residents would no longer pay this tax and Iowans would pay an equivalent amount in income taxes. Therefore, the net savings could be significantly reduced to $95.2 million. It is highly recommended that a detailed survey and analysis of sales and use taxes paid by non residents be conducted before either of these approaches are to be implemented. Significant incidence and equity issues can be raised as the portion of the sales and use tax revenues presently paid by non residents increases.

Another factor that must be resolved is the status and treatment of local option sales taxes which are presently collected by the state and remitted to local units of government. One approach would be to convert all local option sales taxes to local option income taxes. However, the economic consequences on local units of government would depend upon the size of the local sales tax base relative to the local income tax base. Incidence in communities with colleges or located next to interstate traffic may be impacted most.

A third potential offsetting factor is the number of returns that do not itemize deductions on the federal income tax return. This analysis assumes that less than one third of the federal income tax returns itemize deductions. (1) However, the MITA and RTA options provide Iowa taxpayers with a greater incentive to itemize on the federal return increases.

A significant indirect positive factor is that elimination of the 4 percent statewide retail sales and use tax would generate more retail business activity, particularly in trade centers in the counties close to Iowa borders. Previous studies of retail sales indicate that a 4 percent relative difference in retail tax rates is significant enough to alter consumer trade patterns from one trade center to another.

Finally, significant savings in federal income taxes represent retained or new spending in Iowa’s economy. As a result, if
significant savings can be generated, the new spending would contribute to income, employment and economic growth in Iowa’s economy by up to half of one percent annually. This in turn, would generate an estimated 29.5 million in additional state income tax revenues. Thus, the preliminary total new generated revenues is estimated to be $125 million.

In contrast, traditional approaches to balancing the budget by cutting state spending and/or raising taxes would likely have negative short run impacts on state income, employment and economic growth which may exacerbate the present recession.

ANALYSIS OF THE PROPERTY TAX ADJUSTMENT (PTA).

This approach would not eliminate the sales and use tax. The concept of the property tax adjustment is to have state government distribute the present $200 million of property tax credits directly to property taxpayers instead of to local units of government. Technical definitions of these direct payments to individuals would be altered to meet IRS regulations in order to allow Iowa property taxpayers to claim an additional $200 million in gross property tax deductions on their federal income tax returns without paying an addition amount of net property taxes after credits.

The estimated savings for Iowans would be 12 percent of $200 million or $24 million. Depending upon IRS regulations, this approach may or may not require the state credit to be taxable. If so, an alternative might be for Iowa to issue the property tax credits in the form of Iowa sales and use tax certificates which could be used to pay sales and use taxes throughout the year, which would not be taxable. However, this form of PTA may likely create significant administrative and equity issues.

RECAPTURE MECHANISMS.

The recapture mechanisms would likely involve an additional increment to the individual income tax rate adjustment (TRA) and/or the Minimum Income Tax Adjustment (MITA). The important concept is that the recapture increment (RI) would not recapture all of the federal income tax savings. This would allow state tax revenues to increase while the overall tax burden of Iowans declines, because the state tax increase would be less than the federal income tax savings. Perhaps a politically determined approach might start the bidding at 75 percent of the savings to the state and 25 percent of the savings to the individual taxpayers.

LONG-TERM OUTLOOK.

It is highly likely, that if Iowa were the first in the nation to achieve the estimated federal income tax savings by shifting state tax policy, other states would observe and follow suit. This may
in turn create an incentive for Congress to consider whether to make all state and local taxes non deductible within a few years decade or so. One colleague estimates the time for Congress to respond is 2 years. Another estimates that Congress will not respond at all if state politics prevent it.

IN SUMMARY

This preliminary analysis indicates that $75 to $175 million in federal income tax and indirect revenue savings could potentially be generated for Iowa taxpayers by replacing the Iowa Sales and Use Taxes with a revenue neutral adjustment to the Iowa Individual Income Tax. Factors which may partially offset this amount include replacement of sales use taxes paid by non residents and treatment of local option sales taxes. On the other hand, border communities would experience increases in retail sales and significant federal income tax savings within Iowa would contribute to stimulating growth in income, employment and Iowa's economy. Therefore, this preliminary analysis provides sufficient basis for more thorough analysis by more sophisticated models and by policymakers.

References:

(1) Iowa Individual Tax Model, Legislative Fiscal Bureau.