BACKGROUNDER

Thursday, January 22, 2009

Understanding local income surtax in Iowa

A local income surtax is a tax levied by local governments that is based on the amount of state individual income tax due and generates revenue that goes directly to those local governments. Local income surtaxes have been in use in Iowa since the early 1970s, when they were authorized for use by school districts. This use is now widespread, with 297 school districts (82 percent of all school districts) in 98 of Iowa's 99 counties levying a local income surtax as a substitute for additional property tax levies.[1] If local voters approve use of the income surtax, school districts may set rates up to 20 percent. Most school districts had a rate between 6 percent and 10 percent during FY2009.[2]

Counties are also authorized to use income surtaxes, but only to fund emergency medical services (EMS). State law does not currently allow cities to use income surtaxes to generate revenue or reduce property tax levies. A state statute authorizing cities and counties to levy local income surtaxes, subject to voter approval, would likely set a ceiling rate for the tax, similar to the one currently set for school district income surtaxes.

How does it work?

The local income surtax has a very simple administrative structure because it is assessed as a percentage of the statewide income tax. For instance, if a taxpayer in Cedar Rapids owes $1,000 in state income tax and if the local income surtax rate in Cedar Rapids is 5 percent, the amount owed in local income surtax to the city of Cedar Rapids would be $50 (5 percent of the $1,000 owed in state income tax). Importantly, the surtax rate applies only to the income tax amount owed to the state, *not* to the taxpayer's taxable income. Local income surtaxes also only apply to state individual income tax liability, meaning they do not affect businesses that pay only corporate income tax.

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[1] The Legislative Services Agency's December 2008 Issue Review, "Income Surtaxes," provides complete background information on the use of income surtaxes by school districts. School districts may use an income surtax to fund specific discretionary education programs: the Instructional Support Program, the Educational Improvement Program or the Physical Plant and Equipment Levy (PPEL). Total funding for these programs is statutorily limited and can be generated through a combination of property tax and income surtax.

[2] Legislative Services Agency. Out of the 362 school districts in the state, 166 (46 percent) had rates between 6 and 10 percent during FY2009, while 58 school districts (16 percent) had rates between 1 and 5 percent, 73 school districts (20 percent) had rates over 10 percent, and 65 (18 percent) school districts did not levy a local income surtax, either because they had no eligible program to fund (10 school districts) or chose not to use surtaxes for eligible programs (55 school districts). The specific mix of funding sources (property tax and income surtax) for eligible programs is determined by each district; however, the combined surtax rate for all these programs may not exceed 20 percent.

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As it does already with the local-option sales tax, the Department of Revenue would collect the local income surtaxes and remit them back to cities and counties; local governments would therefore have no additional administrative responsibilities. State income tax return forms already include a line for the school district surtax and the county EMS surtax, asking taxpayers to look up their school district/EMS surtax rates on a separate table and to simply multiply that rate by the amount they owe in state taxes. The same process would apply to city or county surtaxes. Taxpayers would then be able to deduct the amount they pay in local income surtax on their federal tax returns.

Amount owed in state individual income tax X **Local income surtax rate** = **Amount owed in local income surtax**

Surtaxes are simple

The illustration above shows how simple it is to calculate taxes owed with a local income surtax. This makes it easy not only for taxpayers to comply with and understand the tax, but also makes it easy for local governments to administer the tax. It also shows that the surtax rate is applied not to taxable income, but to the smaller figure of state income taxes owed.

The most basic type of local income surtax applies only to residents of the jurisdiction levying the tax, meaning that a city with an income surtax would only tax people who lived within that city. However, cities provide services to nonresidents who work within the city. With this in mind, a local income tax can be designed so that it applies to people who work in a city and live outside the city limits, usually by using earnings as the tax base. In this "hybrid model," which is used in some form in Ohio, Michigan, New York and Pennsylvania, both residents and nonresidents are taxed.[3] Usually taxpayers are able to use one tax liability as a credit against the other, meaning that they are not taxed twice on their income, both in their place of residence and their place of employment.

If both counties and cities in Iowa are authorized to levy a local income surtax, some discussion of this structure and how the two taxing authorities would coordinate revenue and tax rates would have to take place. This analysis focuses on issues related to city income surtaxes.

How much revenue would it generate?

Income surtaxes have the potential to generate substantial amounts of revenue for Iowa cities, depending on the size of the income tax base and rate in each city. Table 1 (next page) shows estimates of revenue for various rates.[4] For instance, Cedar Rapids could raise an estimated $5.8 million in local income surtax revenue with a 5 percent rate, but that amount could climb to $23 million with a 20 percent rate.

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[3] The Ohio Department of Revenue provides a helpful description of the structure of their municipal income tax, along with a description of other states' local income tax systems, at http://tax.ohio.gov/divisions/communications/publications/brief_summaries/2006_Brief_Summary/municipal_income_tax.pdf.

[4] Income tax data is not available by city in Iowa, but it is available by county because counties are authorized to levy income surtaxes for emergency medical services. In order to estimate revenue generated by income surtaxes in Iowa's large- and medium-sized cities, we calculated the aggregate income for each county and city and created a factor with which to weight the total income tax paid in each county to estimate the share of county income tax payments made by city residents.

Table 1: Iowa Cities Can Generate Needed Revenue from Local Income Surtax

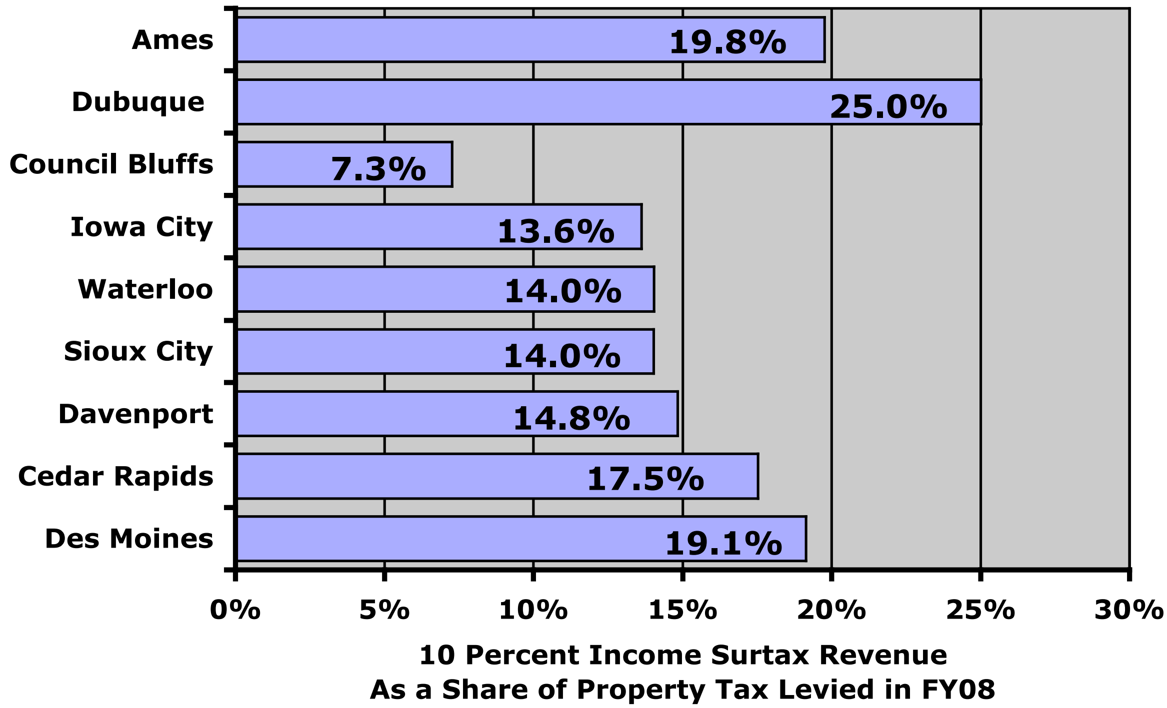
City	Estimated Aggregate State Income Tax Paid By City Residents (2006 tax returns)	Estimated Revenue from Various City Income Surtax Rates		
		5%	**10%**	**20%**
Des Moines	$178,198,252	$8,909,913	$17,819,825	$35,639,650
Cedar Rapids	$116,408,293	$5,820,415	$11,640,829	$23,281,659
Davenport	$76,599,486	$3,829,974	$7,659,949	$15,319,897
Sioux City	$48,678,161	$2,433,908	$4,867,816	$9,735,632
Waterloo	$46,749,623	$2,337,481	$4,674,962	$9,349,925
Iowa City	$54,427,384	$2,721,369	$5,442,738	$10,885,477
Council Bluffs	$23,295,711	$1,164,786	$2,329,571	$4,659,142
Dubuque	$43,601,023	$2,180,051	$4,360,102	$8,720,205
Ames	$39,746,443	$1,987,322	$3,974,644	$7,949,289
West Des Moines	$73,957,326	$3,697,866	$7,395,733	$14,791,465
Ankeny	$45,232,578	$2,261,629	$4,523,258	$9,046,516
Cedar Falls	$29,940,978	$1,497,049	$2,994,098	$5,988,196
Urbandale	$47,275,375	$2,363,769	$4,727,537	$9,455,075
Bettendorf	$40,589,020	$2,029,451	$4,058,902	$8,117,804
Marion	$30,701,458	$1,535,073	$3,070,146	$6,140,292
Mason City	$19,772,681	$988,634	$1,977,268	$3,954,536
Clinton	$16,587,972	$829,399	$1,658,797	$3,317,594
Marshalltown	$16,148,575	$807,429	$1,614,858	$3,229,715
Burlington	$16,695,251	$834,763	$1,669,525	$3,339,050
Fort Dodge	$19,678,559	$983,928	$1,967,856	$3,935,712
Ottumwa	$12,124,269	$606,213	$1,212,427	$2,424,854
Muscatine	$16,965,356	$848,268	$1,696,536	$3,393,071

Sources: U.S. Census Bureau, 2005-2007 American Community Survey 3-Year Estimates; Iowa Department of Revenue, "2006 Individual Income Tax Annual Statistical Report."

According to the National League of Cities, Iowa cities are more dependent on the property tax than the national average, relying on property taxes for 40 percent of municipal revenues.[5] Nationwide, cities in states that allow local income taxes have an average property tax reliance of only 24 percent.[6] Figure 1 shows the revenue from a 10 percent local income surtax as a share of the property tax levied in Iowa's largest cities during FY2008. For instance, the estimated revenue that could be generated from a 10 percent income surtax in Cedar Rapids is equivalent to 17.5 percent of Cedar Rapids' FY2008 property-tax revenues. On average, a 10 percent local income surtax generates revenue equal to about 18 percent of revenue generated from property taxes. The additional revenue generated by the local income surtax could be used to replace a portion of revenue now generated by the property tax, thereby diversifying the tax base.

[5] Hoene, Christopher and Michael Pagano. *City and State Fiscal Structure*. Washington, DC: National League of Cities, 2008. For a full description of the role of property tax in Iowa city finances, see Beth Pearson and Peter Fisher. *City Revenue and Smart Growth*. Iowa Policy Project, November 2008.
[6] Hoene and Pagano.

Figure 1: Local Income Surtax Has the Potential to Substantially Impact Property Tax Levies in Iowa's Largest Cities



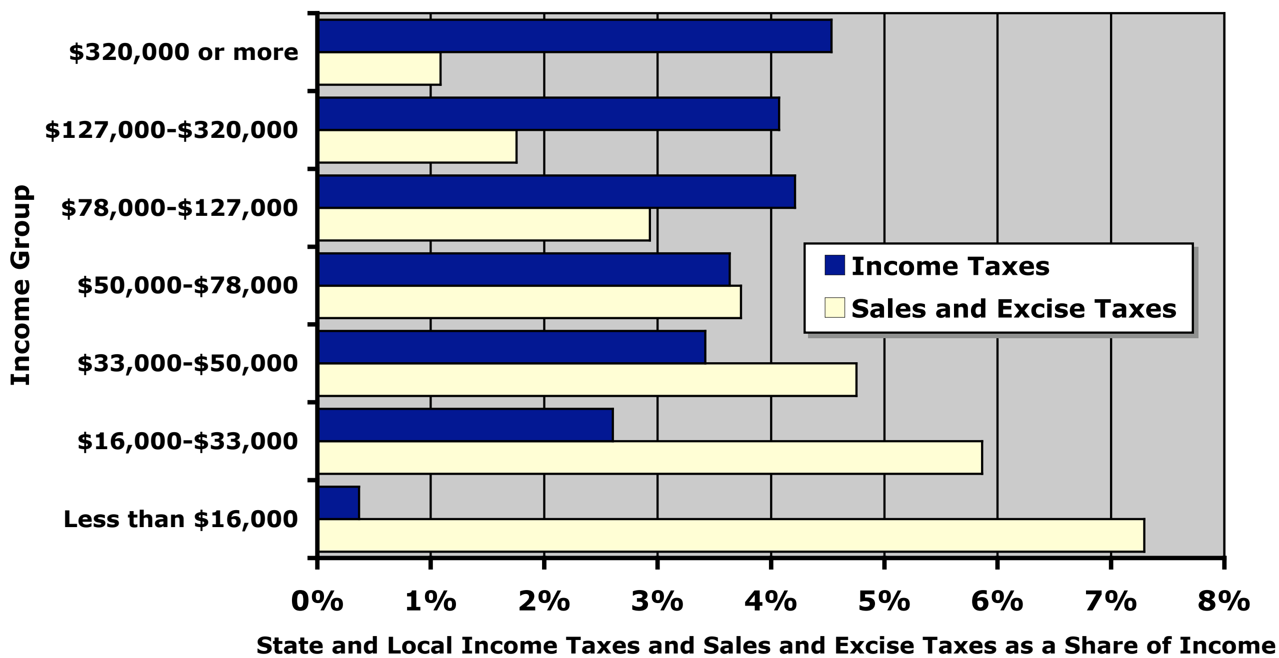
Sources: U.S. Census Bureau, 2005-2007 American Community Survey 3-Year Estimates; Iowa Department of Revenue, "2006 Individual Income Tax Annual Statistical Report"; Iowa Department of Management, City Budget Files by County, FY 2008.

How would a local income surtax affect people at different income levels?

Unlike other options for local revenue generation, income surtaxes are structured fairly so that they do not disproportionately impact low- and middle-income taxpayers. Figure 2, below, compares current state and local sales and income taxes as a share of income and shows how income taxes take up a decreasing share of lower incomes. This is in direct contrast to sales and excise taxes, which take up a larger share of low-income budgets than of high-income budgets.

Local income surtaxes are much fairer ways to raise revenue for cities because they are sensitive to residents' ability to pay taxes. Of course, because they are levied locally, income surtaxes cannot promise to equitably distribute revenue among localities according to need. The revenue each city can generate will depend solely on the size of its income tax base and its rate. Disparities among cities with regard to the size of the income tax base remain in place since this revenue would not be pooled at the state level and redistributed, as is the case with the statewide income tax. However, in some cases, and depending on the design of a statute authorizing income surtax authority to local governments, a city income surtax could raise levels of revenue comparable to those from a local option sales tax (LOST). This is because state law mandates that LOST revenue be pooled and shared at the county level by all jurisdictions that have approved the local sales tax, using a formula based on a combination of property tax levies and population. In practice, this means that the larger cities where most of the sales tax revenue is generated receive a smaller share of that revenue after it is distributed to other jurisdictions in the county.

Figure 2. Income Taxes Structured to Generate Revenue More Fairly



Source: Institute on Taxation and Economic Policy, 2008.

Depending on the income surtax rate and the size of the income tax base, a large city in a county where many other jurisdictions have approved a LOST could generate more revenue through an income surtax (where it retains all revenue generated from the surtax) than through a LOST (where it must share a substantial portion of the revenue generated from city taxable sales). For instance, Department of Revenue data show that Dubuque received just over $7.7 million in LOST revenue during FY2007. According to estimates in Table 1, above, a 20 percent local income surtax in Dubuque would generate $8.7 million. In Cedar Rapids, where city leaders have estimated that a local-option sales tax could generate between $18 million and $23 million (depending on how many jurisdictions in Linn County approve the tax in addition to Cedar Rapids), an income surtax could raise an estimated $11.6 million at a 10 percent rate and as much as $23.3 million at a 20 percent rate.[7]

Conclusion

Allowing cities to put an income surtax on the ballot would give voters more choice in how they would like to generate needed revenue. In contrast to existing choices that disproportionately affect low- and middle-income residents, income surtaxes are structured fairly and are sensitive to taxpayers' incomes. In addition, cities would have more flexibility to respond to high property-tax levies by choosing to replace a portion of the property tax with revenue from an income surtax.

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[7] Smith, Rick. "C.R. switches gears on sales tax." *The Gazette*, page 1A. December 23, 2008.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint fiscal policy initiative of two nonprofit, nonpartisan Iowa-based organizations, the Child & Family Policy Center in Des Moines and the Iowa Policy Project in Iowa City. IFP reports are available at www.iowafiscal.org.