

THE ILLINOIS TAX SYSTEM

State tax systems are evolving rapidly. Across the nation, personal income taxes have become relatively more important in the past two decades, and property taxes have declined in importance, as states have assumed a greater role in funding education and other functions of government and local government funding responsibilities have become relatively less important. Yet Illinois has bucked these trends, continuing to rely on regressive local property taxes as the primary source of school funding. This chapter examines the state and local tax structure by comparison to other states, and looks at trends in Illinois tax revenues over the past two decades. We also estimate the distribution of state and local tax liability by income levels in 2000, and estimate the distributional impact of tax changes enacted during the 1990s.

The Illinois Tax Burden: How High?

Several measures are frequently used for cross-state comparisons of tax burdens. Illinois' state and local tax burden can be seen as somewhat above average, or somewhat below average, depending on which of these measures is used.¹ In particular:

- Expressed as a share of gross state product, taxes in Illinois are 33rd highest in the nation, more than five percent below the national average—and lower than all but one of the surrounding states.
- As a share of total personal income, state and local taxes in Illinois are more than four percent below the national average. At 10.3 percent of income, Illinois' tax burden ranks only 35th highest in the nation—and lower than all but one of the surrounding states.
- On a per capita basis, Illinois state and local taxes are the 15th highest in the nation, more than 4 percent higher than the national average—and second highest among surrounding states.

Total State & Local Taxes in 1999: Three Measures

	% of GSP	Rank	% of Pers. Inc.	Rank	Per Capita	Rank
Illinois	8.6%	33	10.3%	35	\$3,131	15
Indiana	8.7%	31	10.2%	36	\$2,621	32
Iowa	9.1%	27	10.6%	26	\$2,674	28
Kentucky	8.9%	30	10.8%	20	\$2,464	39
Michigan	9.8%	14	10.9%	19	\$3,032	16
Missouri	8.3%	37	9.9%	40	\$2,565	37
Wisconsin	10.9%	3	12.4%	3	\$3,317	7
ALL STATES	9.1%		10.8%		\$2,992	
Addendum: Illinois as a % of National Average						
	94.8%		95.5%		104.6%	

SOURCE: Bureau of Economic Analysis; Bureau of the Census. GSP data is fiscal 1998.

Each of these measures offers some insight, but each has its limitations as a measure of tax burden.

¹All statistics presented here include both state and local taxes. Because states vary in the proportion of their revenues raised at different government levels (i.e., state versus local), limiting our analysis to only state (or only local) revenues would greatly distort the state-by-state comparisons. For an example of how the omission of local government revenues can skew state rankings, see "An Analysis of The Cato Institute's 'The Case Against a Tennessee Income Tax,' (1999) Institute on Taxation and Economic Policy, at <http://www.ctj.org/itep/tncatoan.htm>.

State and local taxes include all tax revenues raised by state and local governments, mostly from property taxes, consumption taxes, personal income taxes, and corporate income taxes. Excluded from taxes are (1) user fees charged for government-provided services, gross interest income, and amounts paid into employee pension, workers' compensation and unemployment trust funds; (2) a small amount of miscellaneous non-tax revenues; and (3) funds from federal assistance.

The most recent state and local tax figures cited here are for fiscal 1998-99, the latest year for which the U.S. Bureau of the Census has published data for combined state and local taxes for all states.

For example, measuring taxes on a per capita basis tells us that Illinois residents pay more taxes per person than do residents of most states—but tells us nothing about *why* this is so. Various factors can explain different levels of state tax burdens, including differences in income levels, the cost of providing government services in the state, and the level of services demanded by the public. In particular, since Illinois residents enjoy higher per-capita income than any of the surrounding states (and had the eighth-highest per-capita income nationally in 1999), it should not be surprising that the state’s per-capita tax burden is above-average. Moreover, the “per capita” measure tells us nothing about the percentage of state tax revenue that is actually paid by Illinois residents; many states use sales taxes and business taxes to export a substantial part of their aggregate tax burden. In states that rely heavily on such taxes, the “per capita” measure can significantly overstate the real tax burden facing state residents: for most years, the state with the highest state per-capita tax burden is Alaska, which raises more than half of its taxes through sources that are exported out of state, such as severance and corporate income taxes.

Measuring tax burdens as a percentage of income represents a substantial improvement in that it takes account of a state’s overall “ability to pay” taxes. For this reason, our analysis will focus primarily on this measure of tax burdens.

Tax-by-Tax Variation in 1999

There is considerable variation in the level of particular Illinois taxes: some taxes are comparative quite low, while others are relatively high. The following chart shows individual Illinois taxes as a percentage of personal income in fiscal 1999.

- While the Illinois personal income tax and consumption tax burden is comparatively quite low, the property tax burden is relatively high. The state and local income tax burden on Illinois residents was more than twenty percent below the national average in 1999—and the property tax burden was about twenty percent *above* the national average.
- Both personal income tax and consumption tax burdens rank, in the aggregate, in the lowest third of

State and Local Taxes as a Share of Personal Income, 1999

	Personal		Sales & Gross		Property		Other Taxes	
	Income Tax	Rank	Receipts Taxes	Rank	Taxes	Rank		Rank
Illinois	2.0%	37	3.3%	36	3.8%	12	1.2%	29
Iowa	2.4%	33	3.5%	33	3.5%	15	1.1%	30
Indiana	2.8%	18	3.1%	39	3.4%	19	0.9%	41
Kentucky	3.6%	8	4.0%	22	1.9%	44	1.5%	13
Michigan	2.7%	22	3.4%	34	3.2%	22	1.6%	12
Missouri	2.7%	21	4.0%	21	2.3%	39	0.9%	46
Wisconsin	3.7%	6	3.6%	29	3.9%	11	1.2%	26
All States	2.5%		3.8%		3.2%		1.3%	
Addendum: Illinois as a % of national average								
	78.6%		87.1%		120.4%		91.6%	

Source: Bureau of Economic Analysis; Bureau of the Census

states nationally. The Illinois property tax burden is in the top third of states nationally.

- The Illinois personal income tax burden ranks substantially lower than that of all neighboring states. Only Indiana has a lower aggregate consumption tax burden among neighboring states—and only Wisconsin has a *higher* aggregate property tax burden.²

²One implication of this imbalance in the Illinois tax system is that substantial changes could be enacted without significantly raising the state’s ranking. For example, if the Illinois income tax rate had been a flat 5

- And of the 41 states that levied broad-based income taxes in 1999, only four states' income tax burden was lower than that of Illinois.

Illinois also has very different reliance on tax- and non-tax revenue sources. In 1999, Illinois ranked sixth nationally in the percentage of own-source general revenues derived from taxes, with almost 75 percent of total own-source general revenues coming from taxes. This means that non-tax general revenues—primarily user fees on highways, sewers, education, hospitals, and parks—represent an especially low share of Illinois state and local revenues compared to most other states.³ This also means that focusing only on tax revenues tends to overstate the cost of Illinois government compared to other states. Inclusion of non-tax own-source revenues drops the state's revised "tax burden" even further, to 47th highest in the nation in fiscal 1999.

Taxes as a % of Own-Source Revenues

	1999	Rank
Illinois	75.6%	5
Iowa	65.5%	36
Indiana	67.2%	34
Kentucky	68.7%	26
Michigan	69.5%	22
Missouri	71.7%	14
Wisconsin	73.1%	9
ALL STATES	70.1%	
IL/ US avg	107.8%	

SOURCE: Bureau of the Census

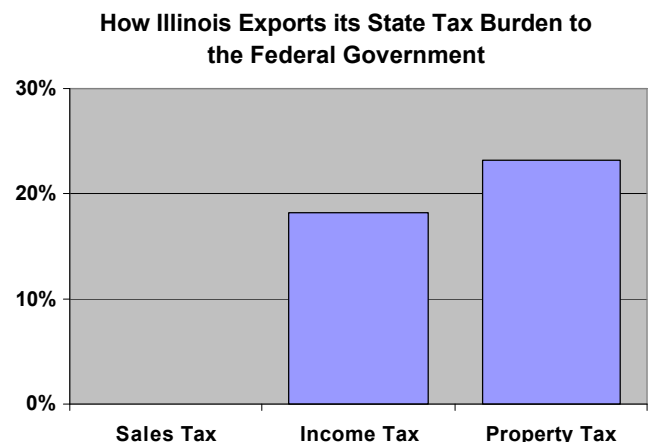
Limitations of Aggregate Tax Data

The primary problem with the aggregate measures of tax burden presented so far is that they tell us little about whether specific groups of taxpayers experience Illinois as a low-tax, high-tax, or average tax state. Taxes can affect taxpayers differently depending on their income levels, the composition of their income, their family size, whether they own a home, and many other factors. Most states provide targeted tax provisions aimed at particular income or demographic groups—and the impact of these tax breaks is concealed by focusing on the aggregate tax burden. Any particular Illinois taxpayer might experience a higher or lower tax burden as a resident of a different state, regardless of the aggregate tax burden in each state.

Another problem with aggregate measures of tax burden is that they include all taxes collected in the state, regardless of whether the residents of the state pay those taxes or not. In fact, a significant portion of the taxes paid by businesses to the state of Illinois are not ultimately paid by Illinois residents at all, but are "exported" out-of-state and paid by non-residents. Much of the Illinois business tax burden ultimately is paid by non-Illinoisans through either higher prices on goods and services exported from Illinois or lower returns on profit for out-of-state investors in businesses operating in Illinois. Of course, this works both ways: Illinoisans pay business taxes imposed by other states. But a state can be a net exporter or importer of business taxes depending on the tax policies it chooses. Thus, the business tax component is another reason these aggregate statistics do not tell the whole story.

The Importance of Interaction with the Federal Income Tax

The ability to deduct some taxes on federal income tax returns also affects comparisons of tax burdens between states. The more a state relies on deductible taxes (such as income and property taxes) the lower the federal taxes paid by its citizens. The citizens of states relying more heavily on deductible taxes



percent rather than 3 percent in 1999, the income tax would still have been below average in 1999 .

³ While the state's reliance on tax revenues has declined significantly over the past two years, the same trend has been evident nationally, so the state's national ranking has remained unchanged over this period.

have lower total tax burdens—state, local *and federal*—than the residents of states relying more heavily on non-deductible taxes (such as the general sales tax). In 2000, Illinoisans paid over \$2.9 billion less in federal income taxes because of the state’s reliance on deductible personal income and property taxes than they would have if the state relied entirely on non-deductible taxes. In 1995, federally deductible taxes accounted for more than 55 percent of Illinois’ total state and local tax revenue.

The Impact on an Illinois Family with \$75,000 of Income of Paying Deductible Instead of Non-Deductible Taxes

Deductible Taxes		Non-Deductible Taxes	
State Property Tax	\$ 1,400		
State Income Tax	1,900	Non-Deductible Taxes	\$ 3,300
Total State Taxes	3,300	Total State Taxes	3,300
Federal Income Tax	8,900	Federal Income Tax	9,400
Total	\$12,200	Total	\$12,700

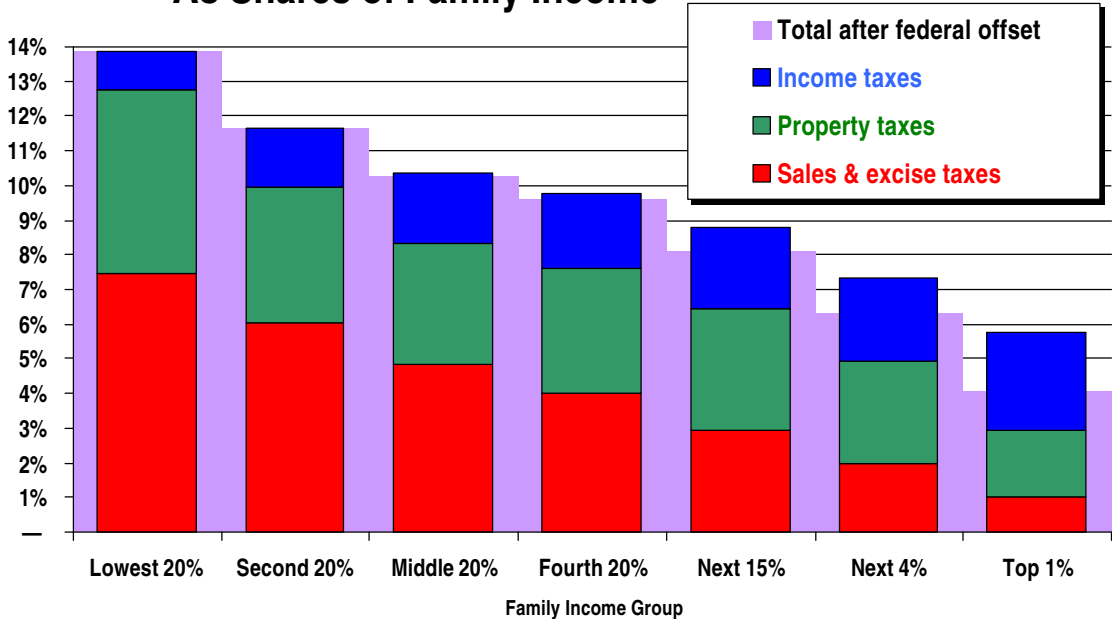
\$500 (15%) of deductible taxes is offset by lower federal tax.

The Distribution of Illinois Taxes by Income Level

The following distributional chart takes into account the federal deductibility and exporting issues that the aforementioned aggregate data cannot address: the distributional chart estimates the net burden of Illinois taxes on Illinois residents at various income levels in 2000. The chart shows that the Illinois tax system is regressive: it requires middle- and lower-income residents to pay a greater share of their income in taxes than it does the wealthy. In 2000, the 20 percent of Illinois residents with incomes under \$15,000 paid 13.8 percent of their income in Illinois taxes. The middle 20 percent of Illinois residents, with average incomes of

\$36,000, paid 10.3 percent of their income in Illinois taxes. And the wealthiest one percent of Illinois residents—with average incomes of \$1.2 million in 2000—paid 5.7 percent of their income in Illinois taxes.

All Illinois Taxes As Shares of Family Income



A regressive tax system is problematic

because it places the largest tax burden on those with the least ability to pay taxes. A ten percent tax burden on middle- or low-income families cuts directly into their standard of living in a significant way. But a similar level of taxation on wealthy families does not as significantly impede their quality of life. This idea is the underpinning of the “ability-to-pay” principle—the idea that wealthier taxpayers can more easily bear the cost of taxes than can lower-income taxpayers. A progressive tax system takes a *larger* percentage of the income of the well-off than it does from those with lower incomes. A regressive tax system—like that of Illinois—does exactly the reverse.

The overall regressivity of the Illinois tax system is due to several factors.

- The state’s personal income tax—generally the only progressive tax levied by states—is relatively unimportant as a revenue source for Illinois—and is levied at a flat rate.

- Illinois property taxes are moderately regressive—but are substantially higher than property taxes in most states.
- Illinois consumption taxes, while not high in the aggregate, are quite regressive.

As mentioned earlier, Illinois income and property taxes can be deducted in computing federal income taxes. But only those taxpayers who itemize their deductions on federal tax returns can take advantage of this. For those who do itemize, their federal tax liability is substantially lowered. Hence, the *net* burden of the Illinois personal income and property taxes, after accounting for the reduction in federal taxes, is lower than it first appears. And because the benefits of itemized deductions go disproportionately to higher-income taxpayers in higher federal tax brackets, the net distribution of Illinois taxes is even more regressive after the federal deductions are taken into account.

For instance, the wealthiest one percent of Illinois taxpayers have, on average, their Illinois tax burden of 5.7 percent offset by a reduction in federal taxes equal to 1.1 percent of income. Thus, the net burden of the Illinois tax system on the wealthiest one percent is 4.7 percent of income—20 percent less than the nominal state tax burden. In contrast, for middle-income Illinoisans, the burden of Illinois taxes is cut by only 0.2 percent—from 10.3 percent to 10.2 percent. This represents just a 1 percent cut in the real Illinois tax burden for this group.

	Total Taxes as a % of Personal Income				% Change in Tax Burden	Change in Rank
	1979	Rank	1999	Rank		
Illinois	10.0%	30	10.3%	35	2%	-5
Indiana	8.8%	43	10.2%	36	16%	7
Iowa	10.1%	29	10.6%	26	5%	3
Kentucky	9.9%	32	10.8%	20	9%	12
Michigan	11.0%	14	10.9%	19	-1%	-5
Missouri	8.8%	45	9.9%	40	13%	5
Wisconsin	11.8%	8	12.4%	3	5%	5
ALL STATES	10.5%		10.8%			
Illinois/U.S. avg	95.7%		95.5%			

SOURCE: Bureau of the Census, Bureau of Economic Analysis

Trends in Illinois Taxes

In the past two decades, total state and local taxes in Illinois have increased slightly as a share of

personal income. In 1979, total state and local taxes were 10 percent of income, ranking Illinois 30th highest nationally. By 1999, Illinois' ranking had fallen to 35th, and the state's tax burden had risen slightly to 10.3 percent of personal income. The Illinois tax burden has remained below the national average throughout this period, and the state's ranking relative to its neighbors has remained generally unchanged. Expressed this way, the Illinois tax burden is substantially lower than the burden in Wisconsin, Minnesota, Iowa, and Nebraska, and is higher than the burden in Missouri and South Dakota.

Illinois has also changed the *composition* of its tax burden. In particular, Illinois' reliance on regressive property taxes has increased relative to other states.

- While the percentage of Illinois taxes derived from the property tax rose only moderately during the period from 1978 to 1998, many other states chose to decrease their reliance on property taxes during this period.⁴ As a result, the state's reliance on property taxes rose from 22nd highest nationally in 1979 to 9th nationally in 1999.

⁴For example, Michigan enacted a sweeping property tax reform that substituted state sales tax revenues for local property tax revenues in 1994.

- By contrast, a moderate increase in the share of Illinois revenues derived from personal income taxes was swamped by a substantial trend towards income taxes nationally, with the result that the state's ranking in reliance on personal income taxes *dropped* from 28th to 35th from 1979 to 1999.
- The state's reliance on sales and excise taxes has decreased substantially; while consumption taxes represented more than 38 percent of total state and local tax collections in fiscal 1979, these taxes comprised only 32.6 percent of total taxes in fiscal 1999. By this measure, the state's reliance on consumption taxes fell from 25th highest in 1979 to 29th highest in 1999.

Even as the state has become more reliant on property taxes—and less reliant on income taxes—compared to national trends, Illinois has become more reliant on local taxes as a revenue source—at a time when states nationwide are moving toward greater reliance on *state* taxes. Illinois relies on localities for an unusually high percentage of total tax revenue. In 1999, 44.1 percent of Illinois tax revenue was raised by localities, ranking the state eighth nationally and highest in the Great Lakes region. Both the local share of revenue and the state's ranking have increased over the past two decades.

Local Taxes as a % of Total Taxes

	1979	Rank	1999	Rank
Illinois	43.6%	10	44.1%	8
Iowa	39.5%	20	36.6%	26
Indiana	34.0%	32	37.5%	23
Kentucky	20.2%	47	24.6%	44
Michigan	37.7%	24	26.9%	42
Missouri	43.0%	12	39.0%	17
Wisconsin	32.4%	34	33.2%	32
ALL STATES	39.0%		38.5%	

SOURCE: Bureau of the Census, Bureau of Economic Analysis

Tax Changes in the 1990s

Many states engaged in major tax reforms during the 1990s, including substantial tax hikes in the early years and a wave of tax cuts during the last five years of the decade. Previous ITEP research has shown

Changes in the Composition of Illinois Revenue, 1979-1999

Year	Individual Income Tax		Sales and Excise Taxes		Property Taxes		Other Taxes	
	%	Rank	%	Rank	%	Rank	%	Rank
1979	15.6%	29	38.2%	25	35.0%	19	11.2%	34
1999	19.1%	36	32.6%	29	37.1%	11	11.2%	25

SOURCE: Bureau of Economic Analysis, Bureau of the Census

that for some states, the net impact of these changes has been regressive.⁵ This section examines the impact of tax changes enacted during the 1990s in Illinois.

By national standards, the tax changes enacted in Illinois during this period were relatively small in scope. Most of the tax changes enacted during the 1990s in Illinois have been part of three tax packages: the 1997 education finance legislation, the 1999 legislation enabling the “Illinois FIRST” transportation funding project, and the 2000 budget. However, Illinois taxpayers also experienced a noticeable—and regressive—tax hike due to the lack of indexation in the tax system.

1997: School Funding Debate

In 1997, various proposals for a major “tax shift” from local property taxes to state income taxes were discussed. These proposals were prompted by a report released by the state Commission on Education Funding in 1996, which identified the state’s high and inequitable reliance on local property taxes as a major reason for the inability of many Illinois localities to adequately fund their schools. Throughout the year, lawmakers considered new ways of funding the state’s schools. Among the options considered were an increase in the state income tax rate and drastic property tax reductions. After much acrimonious debate—and a special session of the state legislature—a revenue-raising measure was enacted into law in December of 1997 that focused not on income taxes but on regressive consumption taxes and gambling revenues. In particular:

- The cigarette tax was increased from 44 to 58 cents per pack;
- The state tax on telephone services rose from 5 to 7 percent;
- The tax rate on riverboat casinos was increased from 20 percent to 35 percent.⁶

As the following table shows, these tax hikes were regressive in their impact—and completely bypassed the recommendations of the Commission on Education Funding.

1999: Illinois FIRST

In 1999 the state legislature passed a five-year, \$12 billion capital development program that relied on increases in excise taxes and vehicle transfer fees to finance the plan. The major tax-related component of the plan was a 6-cent increase in the excise tax on beer, a 90-cent increase in the tax on distilled spirits, and a 15-cent increase in the tax on wine. These changes—while relatively small—were regressive in their impact, since alcohol consumption represents a larger share of income for low-income taxpayers.

⁵*Pennies from Heaven? The Distributional Impact of Massachusetts Tax Cuts in the 1990s*, ITEP and the Tax Equity Alliance for Massachusetts. (1998)

⁶The 1997 legislation actually moved from a flat-rate tax on riverboat casinos to a *graduated* tax. 35 percent is the top rate under this graduated rate structure.

2000: Property Tax Rebates

The fiscal 2000 budget included both temporary and permanent tax relief measures. The largest component of the tax relief was a one-time property tax rebate. The "Homeowners's Tax Relief" rebate was equal to the amount of credit claimed by Illinois income taxpayers under the existing Property Tax credit in the income tax form for tax year 1999, with one important modification—the credit was capped at \$300 per taxpaying household. This rebate was funded entirely by taking \$280 million from the Tobacco Settlement Recovery Fund, creating a new "Homeowner's Tax Relief Fund," and transferring the \$280 million to it. The

Illinois Tax Changes, 1995-2000

Fully Phased-In, 2000 Levels

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	\$8,500	\$21,200	\$35,100	\$55,500	\$94,800	\$229,800	\$1,047,400
Income Range	Less than \$14,000	\$14,000 – \$28,000	\$28,000 – \$44,000	\$44,000 – \$71,000	\$71,000 – \$143,000	\$143,000 – \$531,000	\$531,000 or more
Tax Change as % of Income due to:							
1997 Excise Tax Hikes	0.2%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%
1999 "Illinois FIRST" Excise Tax Hikes	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%
New 5% EITC	-0.1%	-0.1%	-0.0%	-0.0%	—	—	—
Corporate Tax Breaks	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Property Tax Circuit Breaker Expansion	-0.1%	-0.0%	-0.0%	-0.0%	-0.0%	-0.0%	-0.0%
Personal Exemption Hike	-0.2%	-0.2%	-0.1%	-0.1%	-0.1%	-0.0%	-0.0%
Permanent Tax Changes as % of Inc	-0.2%	-0.1%	-0.0%	-0.0%	-0.0%	0.0%	0.0%

ADDENDUM: Temporary Tax Cuts

One-time Property Tax Rebate	-0.2%	-0.1%	-0.1%	-0.2%	-0.1%	-0.1%	-0.0%
Suspension of Sales Tax on Gasoline	-0.2%	-0.2%	-0.1%	-0.1%	-0.1%	-0.0%	-0.0%
All Tax Changes:	-0.5%	-0.4%	-0.3%	-0.3%	-0.2%	-0.1%	-0.0%

Note: This table excludes the effect of the tuition tax credit introduced in 2000. Since nearly half of the poorest Illinoisans are ineligible for the tuition credit, it will do little to mitigate the regressivity of the state tax system and may actually increase it.

Corporate tax breaks modeled include the single sales factor of apportionment and the extension of the research and development tax credit.

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, April 2001

same legislation also created a state Earned Income Tax Credit. The credit is unusual among the 15 state EITC's in existence for tax year 2000 in that it is scheduled to be repealed on December 31, 2002⁷. The EITC is paid for by transferring \$35 million each year from the Tobacco Settlement Recovery Fund to the Income Tax Refund Fund.

Tax Changes Due to Inflation

In addition to the statutory tax changes enacted by the legislature during the 1990s, Illinois taxpayers also experienced a set of income tax hikes that were unauthorized by policy makers at any level. Because certain features of the state tax system are not indexed for inflation, the real value of personal exemptions, lower rate brackets, and income tax credits declines slightly each year when it is not adjusted.

⁷The Illinois approach is not unique, however. Indiana and Colorado have also enacted low-income tax credits that are temporary (in the case of Indiana) or dependent on fiscal surpluses (in the case of Colorado).

Conclusion

For much of the twentieth century, local property taxes were the most important revenue source for state and local governments. While many states have moved toward a greater reliance on state taxes in general and personal income taxes in particular, Illinois has so far avoided this path. As a result, the state continues to rely on local taxes for a greater share of its tax revenue than most states—and continues to rely on property taxes substantially more than most states.

The most common topic of discussion among Illinois tax policy makers during the 1990s was the best way to achieve what some observers saw as an inevitable “tax shift” from heavy reliance on local property taxes to a higher reliance on state income taxes as a source of funding for state and local services. Yet the series of relatively small tax changes that have been enacted in the past several years have done nothing to advance this cause. All of the substantial tax changes enacted since 1997 have focused on regressive excise tax hikes—and while major property tax relief legislation was enacted during the 2000 legislative session, the enacted tax relief was temporary, partially regressive in its impact, and limited to those with personal income tax liability. Moreover, changes enacted in the personal income tax structure during this period—while progressive enough to roughly offset the impact of the recent excise tax hikes—have done nothing to systematically increase the role of the income tax in the state’s revenue system. In short, while the tax changes enacted during the past three legislative sessions have mitigated the regressivity of the tax system to some extent, these changes have failed to address the underlying problems facing the Illinois tax structure.