Balancing Act: Tax Reform Options for Illinois

Institute on Taxation and Economic Policy

February 2002

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This study was funded through a grant from the Joyce Foundation, Chicago, Illinois.

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TAX REFORM OPTIONS FOR ILLINOIS

State and local services and the taxes that pay for them are perennially contentious issues in state houses across the country. In recent years, the rosy economic picture in Illinois has allowed government leaders to make easy decisions—parceling out hundreds of millions of dollars in income, sales and property tax cuts—while postponing more difficult decisions about the long-term adequacy of the state and local revenue stream to pay for important government services.

Yet the recent economic slowdown may soon force lawmakers to confront these hard decisions in the near future. For the first time in several years, lawmakers did not enact substantial tax reductions in the 2001 legislative session, and there are indications that revenue-raising solutions may be necessary to balance the state's books in the short term. If the immediate revenue and spending pressures generated by the 2001 recession force lawmakers to enact tax increases, Illinois policy makers should take this opportunity to step back, assess the impact of their handiwork to date on the state's tax structure, and plan sensible long-term revenue-raising strategies.

This report assesses the Illinois tax system and its effect on economic and social outcomes in the state. The report takes a hard look at the virtues and shortcomings of each of the state's major taxes, evaluates the impact of tax changes enacted in recent years, and assesses a variety of options for tax reform, including revenue-reducing measures, revenue-neutral measures designed to achieve structural tax reform, and revenue-raising measures designed to close the state's looming fiscal gap.

The way Illinois taxes its citizens has both direct and indirect effects on the quality of life for Illinoisans. State policy makers have chosen to tax middle- and low-income Illinoisans more heavily, as a share of their income, than better-off citizens of the state. Swimming against the national tide, they have chosen to increase the state's reliance on local property taxes as a revenue source—and have enacted a series of expensive, poorly targeted tax exemptions from income, sales, and corporate income taxes that diminish the state's ability to provide meaningful property tax relief. This over-reliance in property taxes, combined with the state's relatively low reliance on loophole-ridden income and sales taxes, hits lower- and middle-income Illinoisans especially hard. And many of the tax breaks that undermine the Illinois tax base have been targeted not to the taxpayers most in need, but to the wealthier taxpayers who already pay the least as a share of personal income. By balancing the budget on the backs of the poor in this way, Illinois lawmakers have made it more difficult for low- and middle-income taxpayers to get by. Just as critical, however, is the impact of this regressive tax structure on the state's ability to fund the public services taxpayers demand. The state's low reliance on a narrow-based, flat-rate income tax, its generous yet inequitable sales tax exemptions, and its disproportionate reliance on regressive local property taxes all reduce the long-term yield of the tax system—indirectly undermining the state's ability to provide adequate services to its citizens.

The current fiscal shortfall represents a short-term challenge to Illinois lawmakers—but it also provides an opportunity for lawmakers to craft tax reform solutions that will ensure the long-term solvency of Illinois state and local governments.

We hope this report will prove useful to both the policy makers and the citizens of Illinois as they seek to achieve these dual tasks.

SUMMARY OF FINDINGS

The Current Illinois Tax System

Illinois can be described as either a "high tax" or a "low tax" state, depending on the measure of tax burden used:

- As a share of gross state product, Illinois taxes are more than 3 percent below the national average, ranking 31st nationally.
- On a per capita basis, Illinois taxes are almost 5 percent *above* the national average, ranking 15th nationally—and are second *highest* among neighboring states.

However, measuring tax burdens as a percentage of income is the best of these measures in that it takes account of a state's overall "ability to pay" taxes. By this measure, state and local taxes in Illinois are more than 4 percent below the national average and rank 35th in the nation—lower than all but one of the surrounding states.

Illinois relies more on taxes—and less on non-tax revenue sources such as charges and user fees—than most states. When charges and fees are included, the state's overall "tax and fee" burden is among the lowest in the nation, higher than just 3 states.

While the aggregate Illinois tax burden is comparatively low, certain Illinois taxes are actually *above* the national average. While Illinois income taxes and consumption taxes are relatively low, the state's property tax burden is comparatively quite high, ranking twelfth highest nationally in fiscal 1999. This indicates a fundamental imbalance in the Illinois tax structure.

And despite the low aggregate tax burden, the Illinois tax system is unambiguously regressive. That is, it requires middle- and lower-income taxpayers to pay a higher share of their incomes in taxes than the very well-off have to pay.

- The poorest fifth of all Illinois taxpayers, with incomes of less than $15,000 per year, pays 13.8 percent of its income in total Illinois taxes.
- Families in the middle of the income scale pay 10.3 percent of their income in Illinois taxes.
- The very best-off Illinoisans, the top one percent with an average income of $1.2 million, pay only 5.7 percent of their income in Illinois taxes.

The regressive nature of the Illinois tax system is the result of the interplay between its major taxes: income taxes, property taxes, and sales and excise taxes. These three taxes differ markedly in their impacts on families at different income levels:

- The personal income tax is progressive.
- Property taxes on families are somewhat regressive.
- Sales and excise taxes are extremely regressive.

The regressivity of the state's tax system is compounded by the interaction between state and federal tax burdens. The federal itemized deduction for state and local taxes reduced the average tax burden on the top one percent of Illinoisans by 1.1 percent of income in 2000, while middle-income Illinoisans saw an average reduction of only 0.2 percent. The poorest fifth of Illinoisans see no tax cut from this "federal offset". The deductibility of federal taxes means that a tax system already stacked against lower-income taxpayers becomes even more regressive.

The state's above-average regressivity also gives the lie to the notion that all taxpayers share equally in the "low-tax" status of Illinois. While the tax burden on Illinoisans overall is comparatively quite low, the burden on the very poorest taxpayers is among the highest in the nation.

Trends in Illinois Taxes

The Illinois tax system, already out of balance as the 1980s began, has become ever more unbalanced in the past two decades. The state's reliance on property taxes has continued to increase, at a time when many states have enacted "tax swaps" designed to substitute income or sales tax revenue as funding sources for education. As a result, the state's reliance on local tax revenue sources has increased—also bucking the national trend, and creating worrisome problems of equity for school districts with low property wealth and retail sales.

The 1990s were a period of substantial tax reform activity across the nation. Many states imposed additional taxes during the slow economic growth of the early 1990s and cut taxes during the fiscal surpluses of the late 1990s. 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.

The statutory tax changes enacted during these years were approximately proportional in their impact on taxpayers at different income levels. Yet these tax changes have failed to resolve the underlying structural problems facing the Illinois tax system—and may have worsened the state's long-term ability to fund its activities.

The most common topic of discussion among Illinois tax policy makers during the 1990s was the best way to achieve what many 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 goal. All of the substantial tax increases 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.

The Personal Income Tax

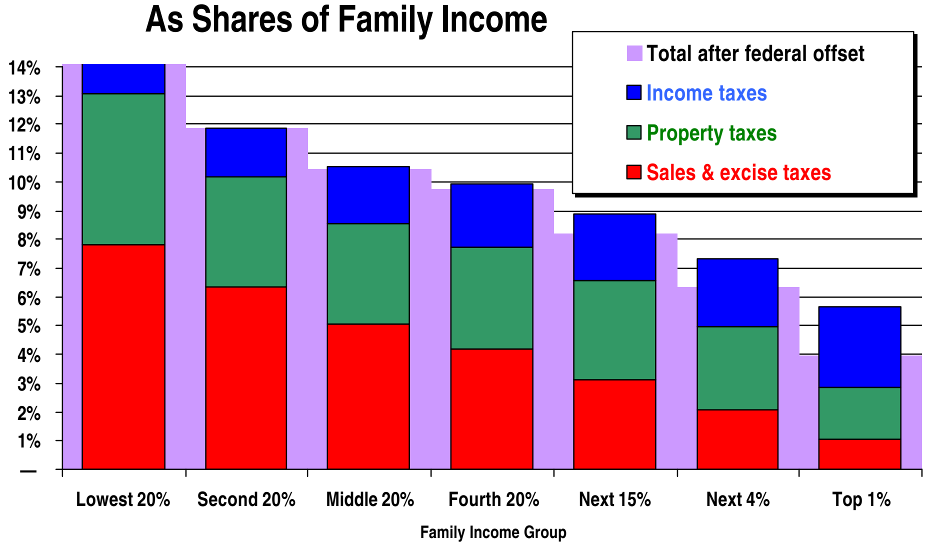
Illinois relies less on income taxes than almost all of the 41 states that currently collect a broad-based income tax—and after controlling for the effects of statutory changes, the Illinois income tax is among the slowest-growing income taxes in the nation. Yet the Illinois tax burden on the very poorest taxpayers is among the highest in the nation. And far from being a progressive tax, the Illinois income tax is almost flat in its incidence on most of the population.

Moreover, when the deductibility of state income taxes on federal income tax returns is taken into account, the Illinois income tax is actually *regressive* across the wealthiest 40 percent of the population. That is, the wealthiest 1 percent of taxpayers—with an average income of $1.2 million—pay *less* in state income taxes, after the federal offset, than do taxpayers in the fourth quintile—a group with an average income of $59,000.

The progressivity and productivity of the Illinois income tax are limited by its flat rate, low exemptions, and the generous—and poorly targeted—set of deductions and credits targeted to specific taxpayer groups.

- Illinois allows an income tax credit for tuition and other school expenses over $250. Because the credit is nonrefundable (that is, it can only be used to reduce income taxes to zero), and because it applies only to education expenses over $250, many low-income taxpayers cannot take advantage of the credit. In the first year of the credit (in tax year 2000), more than half of the poorest Illinois families with children were entirely ineligible for the education credit.
- Illinois allows taxpayers to subtract any and all Social Security income that is taxable for federal purposes. This exclusion is regressive and costly: the wealthiest 10

All Illinois Taxes As Shares of Family Income



percent of elderly Illinois taxpayers receive more than half the benefit from the Illinois exclusion—and the poorest 50 percent of elderly Illinois residents receive one-tenth of one percent of the benefit.

Illinois has followed the lead of more than a dozen states by enacting a state Earned Income Tax Credit based on the federal credit. Yet the Illinois credit is one of the smallest currently allowed by states—and its nonrefundability limits its value to low-income taxpayers. Moreover, the Illinois credit is relatively unusual in that it is scheduled to sunset in 2002.

Illinois policymakers seeking to increase the progressivity of the income tax without compromising the tax base have several promising options: increasing the EITC, creating a refundable dependent care credit, and indexing personal exemptions would all help increase the progressivity of the income tax. And the state's constitutional bar against graduated income tax rates could be surmounted by a progressive tax change combining an increased tax rate with a sharply increased personal exemption.

Consumption Taxes

Illinois consumption tax revenues have grown more slowly than in most states during the past two decades, and its aggregate consumption tax burden is comparatively low—yet the state has one of the highest statutory sales tax rates in the nation. This apparent contradiction is due to the narrowness of the state sales tax base. The Illinois sales tax base is one of the narrowest in the country. Illinois allows exemptions designed to reduce the regressivity of the tax—such as the reduced rates for food, utilities and drugs—as well as exemptions which are accidents of history, such as the almost complete exemption of personal and professional services from the tax. These costly exemptions result in inequitable treatment of consumers with equal "ability to pay" based on their patterns of consumption—and force policy makers to raise sales tax rates in order to raise a given amount of sales tax revenue. to Any substantial reform of the Illinois sales tax should focus on broadening the sales tax base and reducing rates.

While the state sales tax rate of 6.25 percent has not been increased in recent years, many local taxing districts increased their sales tax rates during the 1990s. As a result, the combined state and local sales tax rates in some districts are among the highest in the country. These incremental, locally-enacted tax hikes have the same punishing effect on lower-income taxpayers as would a statewide sales tax increase.

Excise taxes in Illinois are more important as a revenue source than in most other states—and the aggregate burden from these taxes is above-average as well. Illinois has substantially increased its excise taxes on gasoline and cigarettes in recent decades, and now taxes each of these commodities more heavily than most neighboring states.

This increasing reliance on excise taxes is problematic for two reasons: first, excise taxes tend to grow more slowly than the economy. This is because excise taxes are generally applied on a per-unit basis rather than as a percentage of the sales price. This means that if policy makers choose to maintain excise taxes as a revenue source, they must continually raise rates to keep the tax yield growing—which is exactly what lawmakers did throughout the 1980s.

A second, and more fundamental, shortcoming of excise taxes is their extreme regressivity. Even more than general sales taxes, specialized excise taxes on gasoline, cigarettes and other items hit the poorest Illinoisans most heavily as a percentage of income. The sales and excise tax burden is collectively seven times higher on the very poorest Illinoisans than on the wealthiest taxpayers—hardly a tax structure that anyone would design intentionally.

Property Taxes

While property taxes have declined as a share of revenue nationwide, the share of state and local revenue derived from the property tax in Illinois has actually risen somewhat over the past two decades. In fiscal 1999, Illinois property taxes represented 37.1 percent of all taxes collected in the state; only 10 other states derived a greater share of their tax revenue from the property tax.

Property taxes are regressive. This is because home values are a much higher share of income for middle- and lower-income families than for the wealthy. It is common for a middle-income family to own a home valued at two or three times their annual income. Since property taxes are based on property values, they represent a larger share of income from middle-income families than from the better-off.

In addition to being unusually high, the Illinois property tax is unusually regressive by comparison to other states. A 1996 ITEP study found that the state's residential property tax was the 8th most regressive such tax in the nation.

Moreover, the existing Illinois tax credits and exemptions designed to offer property tax relief are poorly targeted. The biggest single property tax relief mechanism, the 5 percent property tax credit, is available only to homeowners, and can only be used to offset income tax liability. This means that income-poor homeowners facing exorbitant property tax burdens can expect no help from the Illinois credit. More generally, non-elderly taxpayers —and taxpayers who rent, rather than owning a home—receive relatively little property tax relief. Any substantial reform of the state's tax structure should reduce the reliance of Illinois local governments on property tax revenue—and should make the remaining property tax burden more equitable through the use of expanded low-income credits.

The temporary property tax "rebate" granted in 1999 did not increase the overall equity of Illinois property tax—and provided an inefficient means of returning surplus tax collections to Illinoisans. While the rebate was roughly proportional—giving almost identical cuts as a percentage of income to most of the income distribution—the taxability of the rebate on federal itemizers' returns means that a substantial percentage of the state tax reduction enjoyed by wealthier Illinois taxpayers was offset by a federal income tax increase.

Corporate Income Tax

The Illinois corporate income tax is under attack. Recent legislation creating a "single sales factor" for corporate profits has carved out special tax preferences for firms selling most of their products out of state. Because several neighboring states have also enacted similar legislation, these breaks collectively reward these firms for doing nothing. In the "race to the bottom" that characterizes midwestern corporate income tax policy, everyone has won—and lost.

The Illinois corporate income tax also faces external pressures. Because the tax is based on federal corporate income definitions, federal loopholes carved out in recent years—and proposed by the current Congress—will further erode the state's corporate income tax base in the future.

Tax Reform Options

In the current economic climate, there will be increasing pressure on Illinois legislators to shore up the income, sales and property tax base —and to raise tax rates. The "Options" section of the report presents 28 detailed options for tax changes in Illinois, coupled with distributional and revenue analyses of each option and an analysis of its strengths and weaknesses. Some of these proposals increase revenues to pay for public services. Others would require reductions in government programs, and still others would leave the aggregate amount of Illinois taxes paid while broadening tax bases and lowering rates.
Among the notable features of these options are:

- the importance of federal deductibility in mitigating the impact of progressive income tax increases—and in blunting the effect of high-end income tax cuts. For the wealthiest taxpayers, close to 40 percent of the state tax reduction for income tax cuts goes not to Illinoisans but directly to the coffers of the federal government in the form of higher taxes paid by itemizers.
- the *non*-deductibility of sales and excise taxes, which means that none of the tax increase from a consumption tax hike will be exported to the federal government—and that every dollar of sales tax cuts will be enjoyed by Illinois consumers.
- the importance of base-broadening as a revenue-raising tool. When lawmakers eliminate costly tax loopholes in the sales, income and property tax, it becomes possible to lower tax rates across the board —treating taxpayers more fairly at all income levels.

NOTES ON PRESENTATION

The distributional tables in this report were produced using the Institute on Taxation and Economic Policy Microsimulation Tax Model.[1] The tables look not only at Illinois taxpayers by

[1]The ITEP model is described in the last appendix. F or a more detailed description of the model and its methodologies, see ITEP's June 1996 report *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* or contact the Institute.

income levels, but when relevant, at categories of Illinois families, broken down by family type and age. The following table shows the relative importance of these demographic groups in 2000.

- 54 percent of Illinois' total population lives in non-elderly married-couple families. These families have 60 percent of Illinois' total income.
- Unmarried non-elderly taxpayers, a group that includes single people with and without children, represent 34 percent of the Illinois population and 24 percent of income.
- The elderly account for 12 percent of the state's population and 16 percent of its income.

2000 Illinois Family Demographics

	% of Adult Population	% of Total Population*	% of Total Income
Married non-elderly	49%	54%	60%
Unmarried non-elderly	34%	34%	24%
Elderly	18%	12%	16%
Addendum:			
Married, all	60%	61%	70%
Unmarried, all	40%	39%	30%

**Includes dependents.*

The distributional analyses presented in this report generally divide the Illinois taxpaying population into quintiles (groups of 20 percent of the population), and further subdivide the wealthiest twenty percent of taxpayers into three subgroups to aid our analysis. The wealthiest 20 percent of the population is both a very important and a very heterogenous group. The table at right shows the distribution of income in Illinois in 2000, broken into the "quintiles" that are used throughout this study.

- Almost sixty percent of all personal income in Illinois goes to the best-off fifth of all taxpayers.
- Taxpayers in the first 15 percentage points of the top fifth earn an average of $101,500. The average income of the top one percent is $1,238,500.
- Lower-income Illinoisans earn a much smaller fraction of total income in the state. The poorest twenty percent of Illinoisans earned just 2.8 percent of state income in 2000.

The Distribution of Income in Illinois
All Families & Individuals in 2000

Income Group		Income Range	Average Income	Share of Total Income
Lowest 20%		Less than $15,000	$8,900	2.8%
Second 20%		$15,000 to $29,000	$21,800	7.0%
Middle 20%		$29,000 to $46,000	$36,400	11.6%
Fourth 20%		$46,000 to $75,000	$59,100	18.9%
Top 20%	Next 15%	$75,000 to $152,000	$101,500	24.3%
Top 20%	Next 4%	$152,000 to $603,000	$224,600	14.1%
Top 20%	Top 1%	$603,000 or more	$1,238,500	21.4%

Here and elsewhere in this analysis, we define "income" to include all cash earnings and transfers, including items not included in "adjusted gross income" (such as tax-exempt interest or most social security benefits) or other narrow, tax-law-based income definitions.