

BUDGET & TAX POLICY INITIATIVE SPECIAL REPORT

**A publication of
Voices for Illinois Children**

November 2002

How Much Is ENOUGH? Assessing the Level of State Services in Illinois



Andrea Ingram, director of the Budget & Tax Policy Initiative at Voices for Illinois Children is the principle author of this report. Special thanks is extended to Jerry Stermer for his steady advice and direction, Emily Mondschein for her dedicated research and analysis, and to the staffs of the Center on Budget & Policy Priorities and the Institute on Taxation and Economic Policy for their technical assistance and analysis. Of course none of this work would be possible without the generous support of the Ford Foundation and the Annie E. Casey Foundation.

To promote discussion of the data and analysis presented in this report, we invite readers to make and disseminate copies.

About Voices for Illinois Children

Voices for Illinois Children is a statewide, non-profit, non-partisan group of child advocates who work with families, communities and policy-makers to ensure that all children grow up healthy, nurtured, safe and well educated. Through policy analysis, public education and outreach,Voices generates support from civic, business and community leaders for cost effective and practical proposals to improve the lives of Illinois children. Jerome Stermer is the president ofVoices for Illinois Children and James J. Mitchell, III is the chair of the board of directors.

About the Budget & Tax Policy Initiative

Investing in our children’s health, education, safety and welfare is the long-term, common sense approach to preserving and enhancing the well being of children, their families and all citizens of Illinois. Smart investment decisions require good information, sound analysis and timely action.

The Budget & Tax Policy Initiative atVoices for Illinois Children is the timely, credible and visible source for state fiscal analysis in Illinois. The project’s work helps Illinois policy-makers and advocates set priorities and make choices that make sense for the short term and for the long haul.

Table of Contents

Introduction	4
Part One: The Tax Burden of Illinois	5
Total Government Revenues	5
A Disproportionate Reliance on Local Taxes.....	5
State Share of Total Tax Burden	6
Distribution of Tax Buren	7
Structural Implications	8
Part Two: Examining Illinois' Revenue Base	9
Income Tax.....	9
Taxation of Services	10
Pension Income Exemption	13
Federal Policies and Existing Tax Expenditures	13
Part Three: Developing an Outcome Driven and Consensus Building	
Budget Process	14
Conclusion	15
Appendix A	16

Introduction

Tax and budget policy decisions often reflect a tension in public discourse over the question, how much is enough? In the United States, the public generally agrees that certain tasks, services, and infrastructure needs are best addressed collectively through government. It is acknowledged, however, that a government in a free society cannot be fully responsible for furnishing a level of comfort and security that diminishes the incentives that are essential for robust economic activity. The appropriate point on the spectrum between too much and not enough will always be the subject of debate as will the question of how we identify when we have reached that point.

The existence of this legitimate debate must not distract us from evaluating the fiscal and human context in which we approach the question of what is the level of government service that is appropriate for Illinois. There are two ways to develop a response to this question. The first involves identifying desired societal outcomes, then calculating the cost of the services, programs, and infrastructure that would be necessary to achieve those outcomes. The second method is to compare Illinois' revenue system and expenditures with other states.

For pragmatic reasons, this paper will focus on the latter method but take guidance from the former. Determining the appropriate level of service by identifying outcomes (or benchmarks) and estimating the cost of targeted programs and services requires a consensus building process. The state government budget process could be the forum for developing that consensus, for debating what we want to accomplish as a society and what we should fund to get it done.

The immediacy of the budget crisis in Illinois demands action before such a process can be fully developed and implemented. A comparative evaluation of the fiscal landscape across the states suggests that the largest reason for Illinois' inability to provide services results from an inadequate revenue stream. An additional \$3.5 billion in state revenues would bring Illinois almost to the average revenues generated by states in this country as a percent of the state's economy as measured by personal income. Invoking this easy measure for the short term does not change the long- term need to target revenue and spending policy decisions towards fulfilling shared outcome objectives.

This paper addresses the major areas that should be considered in any effort to improve and stabilize Illinois' revenue and expenditure system. In Part One, we assess the tax burden in the state both in its aggregate and its distribution. In Part Two, we examine the structural and immediate challenges created by the limits of Illinois' revenue system and identify changes to existing revenue streams that would broaden and stabilize the revenue base. Finally, in Part Three, we consider the advantages of developing a state budget process that is driven by investments in prevention treatment.

Part One: The Tax Burden in Illinois

The burden on Illinois taxpayers of all state and local taxes and fees is relatively low – even when property taxes are included in the analysis. When considering state and local resources like this in the aggregate, the data confirms that the share collected by local governments is high when compared to other states. It can be concluded that Illinois' status as a low tax state results from deficiencies in the system by which the state government collects revenues. This paper identifies three areas in which Illinois' revenues system is outside the norm: income tax structure, taxation of services, and public and private pension income exemptions.

Total Government Revenues

Illinois has one of the lowest tax burdens in the country based on total local and state own source revenues¹ as a percent of the personal income of its taxpayers. The only states with a lower tax burden by this measure are Tennessee and New Hampshire.²

Analysis of public finance revenue as a percentage of personal income is the standard form of measurement. It is considered a better measure for comparisons across states than measures based on per capita for a variety of reasons, including its ability to reflect the relative burden of state and local taxes on state taxpayers and the relative effort that states make to fund public programs.

The personal income in a state is also the determining factor in establishing the extent to which the federal government will share the cost of certain programs and services. The federal formula assumes that states with larger economies as measured by personal income will be able to provide a certain level of service with a lower federal contribution than states with less personal income receive.³ Conversely, lower-income states receive a higher match because it is assumed that they lack the internal resources to provide the same level of service. If the state does not devote resources to such a program in accordance with its capacity, the natural consequence is an overall commitment that is below the national norm.

Because of its capacity as measured by personal income, Illinois receives the lowest federal matching rate for Medicaid (50%) and the Children's Health Insurance Program (CHIP) (65%). (CHIP has been implemented in Illinois as KidCare). An analysis of federal fiscal year 1998 data ranks Illinois 29th in the country in per enrollee Medicaid spending and second to last among the twelve states in the Midwest region. (The Urban Institute and Kaiser Commission on Medicaid and the Uninsured compiled this data based on information from federal reports.)

A Disproportionate Reliance on Local Taxes

Illinois' low ranking for collecting state and local own source revenue results from low state revenue collections rather than low local collections. State taxes in Illinois account for 55.6% of all state and local taxes while the national average is 61.3%—the 8th highest level of dependency on local taxes in the nation. All of Illinois' neighboring states depend less heavily on the local tax base.

¹ The term "state and local own source revenue" is defined as all revenue except federal revenue, liquor store revenue, insurance trust revenue, and utility revenue. It is composed of total taxes plus charges and miscellaneous revenue. The definition includes property taxes.

² Source: Federation of Tax Administrators. This tabulation includes the District of Columbia.

³ This principle is analogous to a key aspect of the Illinois school funding formula. The property wealth in a school district determines which of the state's three funding formulas applies to the district. Districts that qualify for the foundation level formula have a per pupil Equalized Assessed Value (EAV) of less than 93% of the foundation level. For these districts, general state aid is calculated by subtracting Available Local Resources from the foundation level then multiplying that number by the district's average daily attendance. Available Local Resources are calculated based on the districts EAV and an assumed, standard tax rate. The actual tax rate set by a district may be less or more. If a local district does not draw from its local property wealth as expected, then a gap will exist between the foundation level and the actual resources available spend on each child's education.

Illinois Local Taxes as a Percentage of Total Taxes, 1999 Compared to Neighboring States and Large Manufacturing States

State	Amount	Rank
New York	52.9%	2
Texas	47.8%	4
New Jersey	46.4%	6
Illinois	44.4%	8
Ohio	43.7%	9
Florida	40.9%	14
Missouri	39.0%	17
U.S. Average	38.7	N/A
Indiana	37.5%	23
Iowa	36.6%	26
Wisconsin	33.2%	32
California	31%	37
Minnesota	27.4%	41
Michigan	26.9%	42
Kentucky	24.6%	44

Source: Chartbook on Taxes in Maryland, Maryland Budget & Tax Policy Institute, Jan. 2002

State Share of Total Tax Burden

The overall state and local tax burden is comparatively low because the revenues collected by the Illinois state government are comparatively low.

Illinois State Tax Burden as Percent of Personal Income Compared to, National Average, Neighboring States, and Large Manufacturing States

State	State taxes as a percent of personal income*	National Rank	Increase (or decrease) in Illinois state revenues if collected at alternative percentages of personal income** (\$ in Millions)
Minnesota	8.60%	6	\$10,915
California	8.26%	10	\$9,588
Kentucky	8.06%	12	\$8,774
Wisconsin	7.80%	14	\$7,758
Michigan	7.69%	18	\$7,334
New York	6.84%	27	\$3,960
United States—Average	6.75%	N/A	\$3,578
Iowa	6.68%	29	\$3,299
Indiana	6.24%	35	\$1,572
Ohio	6.18%	38	\$1,351
Illinois	5.84%	43	N/A
Missouri	5.80%	44	(\$179)
Florida	5.58%	45	(\$1,044)
Texas	5.07%	48	(\$3,075)

*This percentage is calculated by dividing the state's total revenues by the total personal income of the state's taxpayers.

**The revenue impact is calculated by multiplying the rate at which other states collect taxes by the total personal income of Illinois taxpayers.

The natural consequence of low state revenue collections is higher local taxation as described above. This is best exemplified through the state's dilemma in education financing. Because the state has insufficient resources to invest, local school districts are forced to depend more heavily on available property wealth for funding.⁴ When the state further restricts investments in education because of the state's financial stress, school districts turn to local resources to the extent that they are available. This tension deepens the state's dependency on local taxes and increases the educational investment disparities between districts.⁵ A high dependency on place-based taxation also has a significant impact on growth initiatives and the ability of communities to adequately encourage the development of affordable housing.

Distribution of Tax Burden

A tax burden in a state is assessed both in its aggregate and its distribution. Tax policy influences outcomes as much as policies that are more directly associated with the programs and services offered by the state. As but one example, if the state supports "work first" policies that encourage families to become self-sufficient by providing basic work supports, it is important that the state's tax policies are consistent with that objective. This not only justifies Illinois' earned income tax credit, it also means that when policymakers consider new sources of revenue they should guard against alternatives that undermine the financial security of families who are working towards the state policy objective of self-sufficiency.

Illinois Taxes in 2000							
As Shares of Family Income for All Taxpayers							
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	\$8,900	\$21,800	36,400	59,100	101,500	224,600	1,239,000
Income Range	Less than \$15,000	\$15,000-\$29,000	\$29,000-\$46,000	\$46,000-\$75,000	\$75,000-\$152,000	\$152,000-\$603,000	\$603,000 or more
Sales, excise & gross receipts taxes	7.4%	6.0%	4.8%	3.9%	2.9%	1.9%	1.0%
General sales tax, individuals	3.4%	3.1%	2.6%	2.2%	1.7%	1.2%	0.6%
Excise & gross receipts taxes, individuals	2.1%	1.5%	1.1%	0.8%	0.6%	0.3%	0.1%
Sale, excise & gross receipts taxes, business	1.9%	1.5%	1.1%	0.9%	0.7%	0.5%	0.3%
Property taxes	4.4%	3.5%	3.2%	3.3%	3.2%	2.8%	1.9%
Property taxes on families	4.2%	3.1%	2.8%	2.8%	2.7%	2.0%	0.7%
Business Property Taxes	0.3%	0.4%	0.4%	0.4%	0.5%	0.8%	1.3%
Income taxes	1.1%	1.7%	2.0%	2.2%	2.4%	2.5%	3.0%
Personal income tax	1.0%	1.7%	1.9%	2.1%	2.3%	2.3%	2.6%
Corporate Income Tax	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.4%
Total Before Federal Offset	13.0%	11.2%	10.0%	9.4%	8.5%	7.2%	6.0%
Federal Itemized Deduction Offset	—	—	-0.1%	-0.4%	-1.0%	-1.1%	-1.1%
Net after Federal Offset	13.0%	11.2%	9.9%	9.0%	7.6%	6.2%	4.9%

Source: Institute on Taxation and Economic Policy

⁴ Illinois ranks 48th out of 50 in state share of education funding. Nebraska is 49th and South Dakota is 50th. (U.S. Census Bureau 2000 Annual Survey of Local Government Finances School Systems)

⁵ Per pupil expenditures by Illinois school districts range from \$4,000 to \$17,000. Education Week assigned Illinois an "F" on its report card measuring equity in school financing.

Prior to the enactment of the state earned income tax credit, the distribution of the tax burden in Illinois was one of the ten most regressive tax systems in the country –meaning that the burden was skewed more heavily towards low-income earners than higher income earners.

Structural Implications

The problems in Illinois’ revenue system are historical and structural. A 1996 analysis by noted economists J. Fred Giertz, Therese J. McGuire, and James D. Nowlan demonstrated the existence of a structural deficit in state finances. Expenditures associated with policies that existed at the time were expected to exceed revenues by more than 9 percent within 10 years. The economic boom of the late 1990’s masked, but did not solve, this structural deficit with increased state revenues generated by growth in consumption and capital gains. (Iris Lav, Center on Budget and Policy Priorities, presentation at Voices for Illinois Children, Sept. 11, 2002)

A growing general funds deficit as revealed when Generally Accepted Accounting Principles (GAAP) are used reflects the accumulated impact of revenues falling short of meeting expenditures from year to year. The Detailed Annual Report published by the state comptroller presents the state’s revenues and expenditures for the fiscal year on a budgetary (cash) basis. This analysis recognizes revenue only when they are deposited into the state treasury. Similarly, it recognizes liabilities only when they are paid. This method creates the positive year-end balances that allow the state to consider its budget in balance as required by the constitution.

The Comptroller also publishes a Comprehensive Annual Financial Report that presents revenues and expenditures using GAAP. This method recognizes revenues when they are owed to the state even though they may not be received until later, e.g. after the close of the fiscal year. Conversely, it counts liabilities of the state when they are incurred, even if payment is made in the next year.

The growing deficit appears when GAAP is used, which is the better measure of the states true financial health. By the end of FY 2001, Illinois GAAP balance was negative \$1.3 billion while its cash balance was positive \$1.1 billion.⁶ Illinois GAAP deficit exceeds that of its neighbors.

**GAAP Balances
Illinois, Neighboring States, and
Large Manufacturing States
(\$ in Millions)**

State	FY 1999	FY 2001
	GAAP Balance	GAAP Balance
California	\$2,331	\$7,578
Florida	\$3,528	\$3,426
Illinois	-\$303	-\$1,278
Indiana	\$3,441	\$1,799
Iowa	\$1,720	\$1,511
Kentucky	\$488	\$395
Michigan	\$1,576	\$1,908
Missouri	\$1,531	\$990
Minnesota	\$2,031	\$1,180
Ohio	\$2,640	\$1,881
New Jersey	\$2,170	\$3,299
New York	\$1,646	\$493
Texas	\$2,183	\$2,618
Wisconsin	-\$908.7	-\$1,214

Sources: Illinois Office of the Comptroller; FY 2001 Comprehensive Annual Financial Reports for Illinois, Indiana, Iowa, Kentucky, Michigan, Missouri and Wisconsin.

⁶ The FY 2002 GAAP balance will be available in December of 2002.

Part Two: Examining Illinois' Revenue Base

A variety of actions could be taken to broaden and stabilize the Illinois state revenue base. Significantly, there are three major areas in which Illinois revenue practices are outside of the norm.

- Illinois has a flat income tax of 3%. Illinois taxpayers in the highest income bracket are taxed at a rate that is lower than any other state except Pennsylvania.
- Illinois imposes a sales tax on only 17 of 164 categories of taxable services. Only six states tax fewer services.
- Illinois is one of only three states that completely exempt all public and private pension income from taxation. (“State Taxation of Social Security and Pensions in 2000,” AARP Public Policy Institute).

Illinois can also examine the federal tax policy decisions that impact state revenues and evaluate the effectiveness of existing tax expenditures.

Income tax

Illinois taxpayers in the highest income bracket are taxed at a rate that is lower than in any other state that has an income tax except Pennsylvania. Illinois has a constitutionally mandated flat income tax that is currently 3% on personal income and 4.8% on corporate income. The constitution also requires that the relationship between the individual income tax and the corporate income tax not be greater than a ratio of 5 to 8. By law, the state retains 90% of income tax proceeds and distributes the remaining 10% to local governments.

Revenue Impact of Increased Illinois Individual and Corporate Income Tax* (\$ in Million)

Various Individual and Corporate Income Tax Rates **	Estimated State Revenue	Estimated Increase to State Revenue
3.0% — 4.8% (current)	\$8,129	N/A
3.5% — 5.6%	\$9,484	\$1,355
3.75 — 6.0%	\$10,161	\$2,032
4.0% — 6.4%	\$10,838	\$2,709
4.5% — 7.2%	\$12,193	\$4,064
5.0% — 8.0%	\$13,548	\$5,419

*These calculations are based on Illinois income tax data for fiscal year 2001 as provided by the Illinois Department of Revenue. Arguably this data is more reflective of the revenue impact a tax increase would have in FY 2003 or FY 2004 than the FY 2002 data. This analysis excludes revenue collections that the state returns to taxpayers as refunds and the 10% of collections that the state distributes to local governments.

**These rate increases assume maintenance of the 5 to 8 ratio between the individual and corporate rates.

Increasing the state income tax would have the greatest impact on reducing the gap between Illinois revenues and those collected by other leading states. A restraint in using this alternative, however, is the additional tax burden that it would impose on low and middle-income earners who already pay a disproportionate share of their income to the state through the various taxes and fees collected by the state. An improved state earned income tax credit would reduce that burden.

Raising the income tax rate would lower the state's tax threshold — the income at which a family must pay state taxes. In the first tax year after the enactment of the Illinois EITC in 2000, Illinois' tax threshold climbed from third lowest to eleventh lowest — among states with an income tax.⁷ Illinois' EITC currently is set at 5% of the federal EITC. If a family's tax liability increases, it will exceed the amount of the credit sooner, thereby lowering the state's tax threshold. Families with incomes under \$32,121 with two or more children and families with incomes under \$28,281 with one child qualify for the federal and state earned income tax credit. Targeting a relatively small portion of increased income tax revenues to an improved state EITC would offset most of the additional burden for many of Illinois' low to middle income earners.

⁷ The Illinois tax threshold increased from \$6,600 for a family of four to \$14,000 for that same family. Of that increase, \$1,400 resulted from the final phase in of an increased personal exemption. The remainder directly resulted from the enactment of the Illinois.

**Refundable Illinois EITC— Estimated Cost for Tax Year 2003
(\$ in Millions)**

State EITC At Alternative Percentages of the Federal Credit	5%	10%	15%	20%	25%
Estimated Cost	\$60	\$120	\$180	\$240	\$300

Source:Voices for Illinois Children calculations based on data from the Illinois Dept. of Revenue

The following table examines the impact of increasing the income tax from 3% to 5 % on a 2-parent family with two children and the effect of an increased state EITC.The table illustrates the dynamics of the income tax and the state EITC in just one of many possible scenarios.

**Net Impact of Increased Illinois Income Tax
And Improved State Earned Income Tax Credit
On Low to Mid-Income Earners**

Gross Earnings	Current income tax liability at 3% rate and at state EITC 5%	Income tax liability at 4% rate with existing state EITC level (5%)	Income tax liability at 4% rate with 25% EITC*
\$10,000	\$0	\$0	\$0
\$18,000	\$152	\$252	\$0
\$25,000	\$435	\$605	\$306
\$32,000	\$719	\$959	\$955
\$39,000	\$930	\$1240	\$1240

Source:Voices for Illinois Children

*Unlike the federal EITC, Illinois existing EITC is not refundable. This means that families receive the full benefit of the credit only if their tax liability exceeds (or equals) the credit. If the credit is increased to 25% and made refundable, families with incomes of \$10,000 would receive a refund of \$902 and families with incomes of \$18,000 would receive \$242.

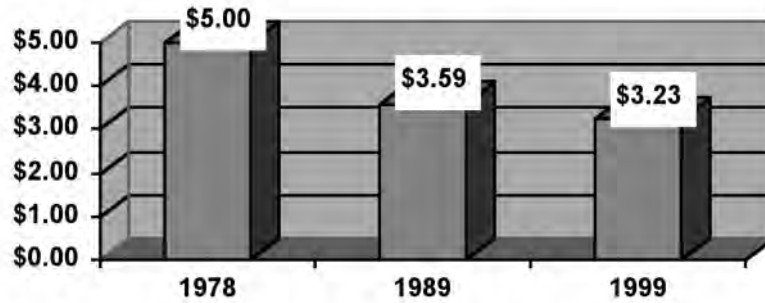
Taxation of Services

Illinois imposes a sales tax on only 17 of 164 categories of taxable services. Only six states tax fewer services. (Federation of Tax Administrators).

Service consumption is an increasingly large part of economic activity. In 1960, consumers spent 41 cents out of every dollar on services. Now, 58 cents out of every dollar is spent on services. (U.S. Bureau of Economic Analysis)

The change in consumer spending habits impacts the revenues that a state realizes from its sales tax. Nationally, in 1978 every penny of sales tax (where one penny equals one percentage point) brought in \$4.99 for every \$1,000 of personal income. By 1999, that same penny resulted in state revenues of just \$4.16 per \$1,000 of personal income. Because of the almost total exclusion of services from the Illinois sales tax, the decline in this state has been even more significant.

Each Penny of Illinois Sales Tax Brings in Increasingly Less Revenue



■ Revenue per penny of sales tax per \$1000 of personal income

Source: Center on Budget and Policy Priorities

Adding a range of services to Illinois sales tax base would reverse this trend. Estimating with a high degree of certainty the revenues that the state could realize from adding particular services is difficult. The table below reflects information compiled by Institute on Taxation and Economic Policy from the U.S. Commerce Department and the Census of Services. The table shows total consumption amounts in calendar year 1997 for each service category by income quintile.

The estimates based on the consumption data in the table are most useful for evaluating the relative value of taxing the various services and the distributional impact on different income ranges. The 1997 data was adjusted for inflation, but the projections do not reflect spending trends in these particular service areas.

**Illinois 2002 Consumption Totals by Service Category
And Estimated State Share of Taxation
(\$ in Thousands)**

Components of Base Expansion	Total	Estimated State Share of Taxation*
Motor vehicle repair labor	\$3,507,049	\$175,352
Cable TV	2,407,027	120,351
Personal Care Services	2,394,835	119,741
Club memberships	1,754,414	87,720
Dry Clean & Laundry	1,261,293	63,064
Fees for participant sport activities	1,010,545	50,527
Movie & Theatre etc.	857,196	42,859
Fees for recreation	830,590	41,529
Gardening/Lawn	687,580	34,379
Housekeeping services	651,906	32,595
Laundry coin-op	504,330	25,216
Vet services	361,789	18,089
Vehicle parking	258,384	12,919
Funeral Service	225,869	11,293
Furniture Repair	213,957	10,697
Pet services	112,127	5,606
Apparel alteration	105,925	5,296
Docking/landing	100,424	5,021
Watch & jewelry	100,262	5,013
Shoe repair	91,486	4,574
Moving storage	76,445	3,822
Towing charges	44,694	2,234
Water softening	19,826	991
Septic tank	18,255	912
Parking	3,550	177
TOTAL	\$17,599,757	\$879,987

*The state retains 5% of the state's 6.25% sales tax, which equals 80% of the total collected. By law, the state is required to distribute the remaining 1.25% of the tax rate (20% of revenues) to local and county governments.

Pension Income Exemption

Illinois is one of only three states (Mississippi and Pennsylvania are the others) that completely exempt all public and private pensions, including social security, from taxation. (“State Taxation of Social Security and Pensions in 2000,” AARP Public Policy Institute). The table below evaluates the impact of alternative methods of the state could consider to tax pension and social security income. Because state taxpayers are entitled to a credit for taxes paid to the state against federal tax owed, the net impact on the taxpayers is less than the total revenue realized by the state. To ensure that eliminating the exemption does not adversely impact our most vulnerable seniors, the state could elect to tax only pension income over a certain income level.

Revenue Impact of Illinois Pension Income Tax Changes, 2002 (\$ in Millions)

Possible Policy Change Variations	Tax Change		
	State	Federal	Net Taxpayer Impact
Tax All Pension Income	\$ +405	\$ -51	\$ +355
Tax Social Security Like Federal	\$ +85	\$ -9	\$ +76
Tax Pension and Social Security**	\$ +535	\$ -62	\$ +473
Tax Pension and Social Security Only for Taxpayers with:			
Total Income over \$50,000 all taxpayers	\$ +304	\$ -48	\$ +256
Total Income over \$75,000 all taxpayers	\$ +204	\$ -40	\$ +473
Tot. Inc > \$50K, \$100K for MFJ*	\$ +183	\$ -39	\$ +145
Tot. Inc > \$75K, \$150K for MFJ	\$ +103	\$ -25	\$ +78

Source: Institute on Taxation and Economic Policy

*Married, filing jointly; **Eliminating the exemption for both social security income and pension income has a combined impact that is greater than the sum of eliminating the individual exemptions. This is because the pension income would count towards the gross income level (\$25,000) at which social security income is taxed under the federal rules, which this table assumes would be used for state purposes.

Federal Policies and Existing Tax Expenditures

Increasing the stability of Illinois revenue system requires policymakers to affirmatively engage in tax policy decisions. Two key areas exist that receive little ongoing attention: federal policy changes and state tax expenditures.

The federal government frequently changes its tax policy to meet federal policy objectives. When these changes impact state revenues, state policymakers should decide how the change impacts state policy goals and priorities. If the change does not serve those goals and priorities, the state should disconnect from the federal rule change to preserve existing state revenues. Passively allowing the consequences of federal policy changes effectively divorces important fiscal decisions from competing policy concerns.

As but one example, during the summer of 2001, the federal government repealed the federal estate tax. Because the definition of Illinois’ estate tax is linked its federal counterpart—as is the case in many states—it will be phased out by function of the federal change unless Illinois policymakers elect to disconnect it. The first year state fiscal impact of the phase-out is estimated to be \$90 million. However, Illinois will lose over \$450 million annually if this revenue stream is completely eliminated as scheduled in 2007. Sixteen states and the District of Columbia have already decoupled.

Because the state lacks a process for evaluating whether federal tax policy changes should be accepted, policymakers are never compelled to face the policy changes that inaction implements. In essence, reducing annual state revenues by \$450 million requires reducing annual state expenditures by \$450 million or replacing the revenue stream. Such a policy choice deserves an active (e.g., non-passive) decision-making process.

Illinois also does not have a system for evaluating the ongoing validity and effectiveness of its tax expenditures. Policy decisions that allocate resources to tax credits or deductions are referred to as “expenditures” because they have the same impact on the pool of resources as spending on services. According to the state Comptroller’s office, tax expenditures adjusted for inflation increased 39 percent in Illinois between FY 1994 and FY 2001. This 4.7 percent average annual increase compared to a 2.9 percent average annual increase in inflation. The Comptroller estimates that tax expenditures in Illinois in FY 2001 exceeded \$5.5 billion.

Tax expenditures exist outside of the normal budget process. Typically, they are enacted as permanent components of Illinois statutory law. Because they are not a part of the annual budget process, tax expenditures do not compete with direct expenditures for a share of the available pool of resources. For the same reasons, there is not a system for holding tax expenditures accountable for achieving their originally intended policy outcome.

These problems could be addressed at least in part by incorporating tax expenditures into the governor’s state budget proposal and the ensuing budget debate. Policymakers would be able to evaluate the ongoing policy validity of each expenditure and weigh its continuation against competing spending priorities.

Part Three: Developing an Outcome Driven and Consensus Building Budget Process

As suggested at the beginning of this paper, the challenge of answering the question of what level of state service is appropriate may best be decided through a process of identifying desired societal outcomes, then calculating the cost of the services, programs, and infrastructure that would be necessary to achieve those outcomes. For such a process to be credible, it must be open and inclusive. To be useful, it must be directly linked to the creation of the state budget and the policy commitments and funding priorities contained in it.

The Bureau of the Budget should be organized in a way that connects long-range planning to the state’s spending priorities and decisions. Currently, the state’s annual budget process involves projecting revenues for the next fiscal year then distributing those revenues based on a competition between the expected cost of current services and new initiatives. This system does not provide an effective platform for the debate that will impact the long-term fiscal health of the state and the quality of life of its citizens, e.g. where should we invest our resources now to minimize future expenses and consequences related to economic and social failure.

Wise investments of public money require thoughtful analysis of desired outcomes, best practices for achieving those outcomes, performance measuring techniques and long-range fiscal forecasting techniques that account for the impact of changed investment strategies on future expenditure needs. For example, fostering an economy that sustains low unemployment at wages that allow families to be self-sufficient may serve the interests of all Illinois citizens. Benchmarks to measure efforts towards reaching that outcome could include net job growth in the state, Illinois’ national rank in new companies, the percent of workers with earnings equal or above the local self-sufficiency measure, Illinois’ unemployment rate as a percent of the U.S. unemployment rate, and others indicators. Successfully directing our resources to impact these benchmarks may adjust trend lines so that ultimately less resources are needed to intervene in the bad outcomes of poverty and economic malaise.

The process of identifying outcomes and benchmarks should seek and reflect the input and advice of civic and community leaders, policymakers and citizens. A series of meetings or sessions would be necessary to allow appropriate thought and discussion. The process itself will develop commitment and faith that state government and its new leadership is directing energy and resources to serve objectives of the citizens of the state of Illinois.

This new process would not be reinventing the wheel. In the spring of 2002, Harvard University's Innovations in American Government program recognized Oregon's work in this area as one of the most effective and innovative in the public sector. The system is constructed in a way that would facilitate ready export of acceptable elements.

Outcomes and benchmarks only become relevant if substantive and fiscal policies are designed to have an impact on them. A budgeting process that integrates these imperatives must consider historical trends and set long-term goals. The process must allow for a level of sophisticated analysis that accepts and considers the influence of outside pressures on agency and benchmark performance.

This is a process that can create an even better Illinois. It will shed light on one of the least trusted areas of state government. A populous with more faith in the goals and the measured consideration that influences state investments will have greater confidence in, and support of, the state services and initiatives that directly impact the quality of life of children, their families and communities in Illinois. It is process worth undertaking.

Conclusion

Policymakers, community and civic leaders too often dispense with state fiscal policy as representing the driest most mundane workings of state government. The perceived complexity of the system and political pitfalls of tax policy persuade them to accept numbers for what they are instead of what they should be.

Debating around the edges prevents us from getting to the point. Many of us place value on the same outcomes. Few would disagree that it is better to educate a child than prepare a prison for his or her eventual housing. Yet we often allow political suspicions to intervene in our willingness to work towards our shared outcome goal. This paper is meant to help us towards reasonable solutions that keep common outcomes squarely on the table.



The Budget and Tax Policy Initiative is a project of
Voices for Illinois Children.

Andrea Ingram
Project Director
(312) 516-5556
aingram@voices4kids.org

Emily Mondschein
Program Associate
(312) 516-5568
emondschein@voices4kids.org

**Budget and Tax Policy Initiative
Advisory Committee**

M. Michael Beacham
Dave Bennett
Steve Bishop
John Bouman
Robin Black
William Burns
Joel Carp
J. Thomas Johnson
Prof. Robert LaLonde
David Marzahl
Prof. Therese McGuire
John Rhine, Chair
Hank Scheff
Bower Tucker
Paula Wolf
Robert Wolters

Jerry Stermer, President

Special thanks to the support of
The Ford Foundation and the
Annie E. Casey Foundation

The Budget and Tax Policy Initiative at Voices for Illinois Children is committed to improving the lives of Illinois children and families and enhancing their access to meaningful opportunities for achievement by engaging families, communities, advocates, and policy-makers in the process of creating a strong and equitable state fiscal structure.

Designed and printed by
Kokopelli Communications Group;
Chicago, IL.

208 S. LaSalle St., Suite 1490, Chicago, IL 60604-1103
312.456.0600 • www.voices4kids.org