Tax Reform:
Improve Fairness and Adequacy in Illinois' Tax System

Illinois is currently experiencing what is arguably the worst fiscal crisis the state has ever seen. Faced with a $5 billion deficit, Governor Blagojevich was forced to make tough decisions to balance the state's budget for the current fiscal year (FY 2004). Still more budget woes appear to be on the horizon for the coming year with published estimates of at least a $2 billion deficit. Most analysts believe the current budget relies too heavily on one-time revenues that will not be available in future years. ***This pattern of large deficits threatens to continue if the state's fiscal system is not fundamentally changed.***

The current structure of Illinois' tax system does not generate adequate revenues to fund existing services; growth in needs (adjusted only for inflation and population growth) far outpaces growth in tax revenues. To remedy this situation, the state must either significantly and permanently cut spending on public services such as education, public safety and health care, or increase revenues. Excessive spending does not appear to be the culprit as Illinois ranks near the bottom in total state spending per capita – 37th nationally.[1] Also, given that total state tax collection as a share of personal income in Illinois ranks even lower nationally – 41st – increasing state revenues seems like a viable option.[2]

Simply increasing the rates on current taxes, however, is not a good response. The Illinois tax system places a disproportionate burden of funding public services on those least able to pay. In fact, low-income families face Illinois' heaviest tax burden making the Illinois system one of the most unfair of any state tax system. At a time when the state is facing unprecedented budget shortfalls, it is important to not only reform the tax system to provide a stable source of revenue, but also to make it more fair to correct the unequal tax burden currently facing low- and moderate-income Illinois families.

Is Illinois a Low-Tax State? State and local taxes in Illinois – measured as a share of personal income – are below the national average, which is why Illinois is often referred to as a low-tax state. However, for low-income Illinois taxpayers, state and local taxes are among the highest in the country. The Illinois tax system is ***regressive*** – it takes a greater share of income from low and middle-income families than it does from wealthy families.

This distorted tax burden is the reason the Institute on Taxation and Economic Policy named the Illinois tax system as one of the ten most regressive in the country[3]. In fact, the poor in Illinois – with an average annual income of $8,900 – pay more than twice as much of their income in taxes than do the wealthiest 1 percent, whose average annual income is more than $1.3 million.

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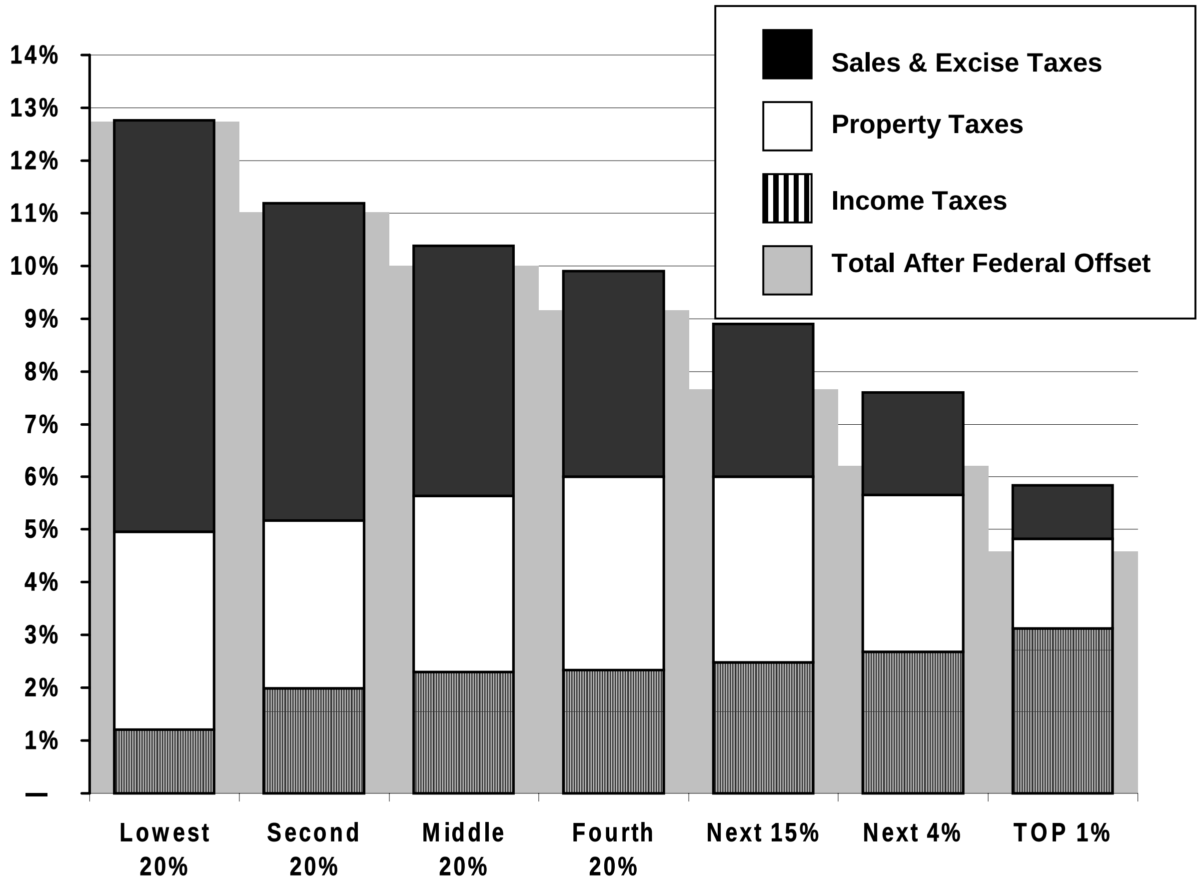
[1] Source: U.S. Bureau of the Census, Governments Division, 2001
[2] Source: Source: U.S. Bureau of the Census, Governments Division, "State Government Tax Collections", 2002; U.S. Department of Commerce, Bureau of Economic Analysis, "Annual State Personal Income", 2002
[3] Source: Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," January 2003. (http://www.ctj.org/itep/whopays.htm)

This disparity is then exacerbated by federal itemized income tax deductions, as taxpayers who are better off are more able and likely to itemize, thus reducing their tax liability.

Illinois State and Local Taxes in 2003
as share of family income by income group for non-elderly taxpayers



Source: Institute on Taxation and Economic Policy

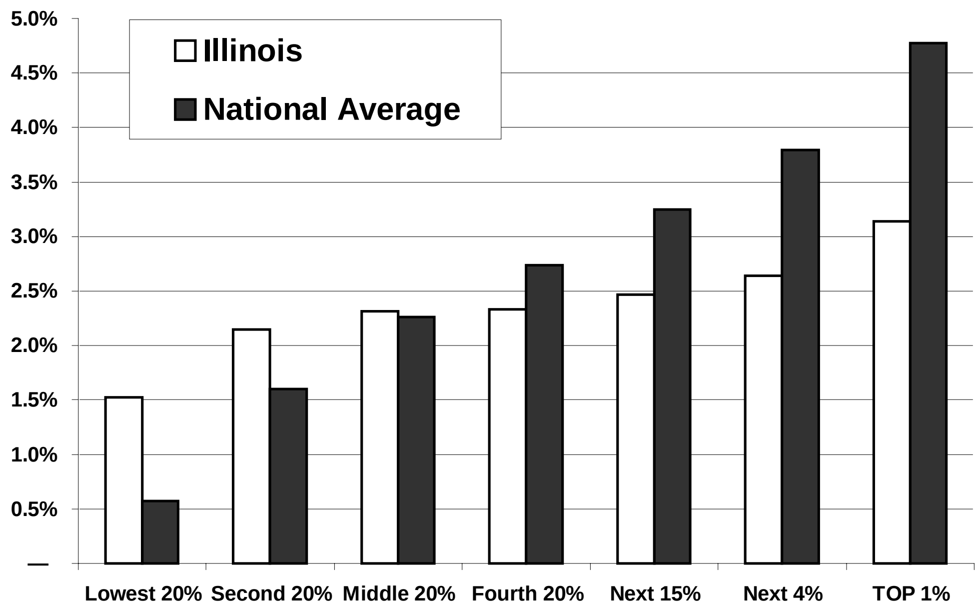
The type of taxes upon which a state relies has significant implications for equity in the tax system, and Illinois' current mix limits fairness. There are three main types of taxes that state and local governments levy in order to fund public services: income, property, and consumption (sales and excise) taxes. Income taxes are the most progressive of these – the wealthiest taxpayers are generally required to pay the highest ***effective tax rate*** – actual percentage of income paid in taxes after all credits are taken into account. Property taxes, on the other hand, are more regressive and typically favor the wealthy as the wealthy are generally faced with the lowest effective tax rate while the poor face the highest. Sales and excise taxes are the most regressive, placing a heavy tax burden on the poor and very little tax burden on the wealthy measured as share of income. ***Reform of the tax system must increase fairness in the entire Illinois tax system while also ensuring that revenues are available to adequately fund public services.***

The Illinois Income Tax

Income taxes are generally the most progressive major component of a state tax system. Across all states, the effective income tax rate for poor families is only about one-tenth that facing the wealthiest families, while in Illinois that figure is closer to one-half. While the Illinois income tax is very slightly progressive, it is clearly well below average when compared to other states.

The main reason the Illinois personal income tax fails to compare well is its constitutionally mandated flat rate – it taxes all individuals at the same rate of 3 percent instead of applying a staggered rate that rises by income bracket. Various deductions and credits that benefit different income groups change this structure slightly as do the effects of the corporate income tax. Taking these into account, the effective income tax rates become 1.2 percent for the poorest Illinois families and increase gradually to 3.1 percent for the wealthiest Illinois families. While the Illinois earned income tax credit targeted to low- and moderate-income working families has helped to reduce the tax burden for these families, the Illinois income tax still imposes one of the nation's highest effective income tax rates on its poorest families while it asks less of its wealthiest taxpayers than virtually all other states.

Illinois Income Tax Compared with National Average (2002)
as share of family income by income group for non-elderly taxpayers



Source: Institute on Taxation and Economic Policy

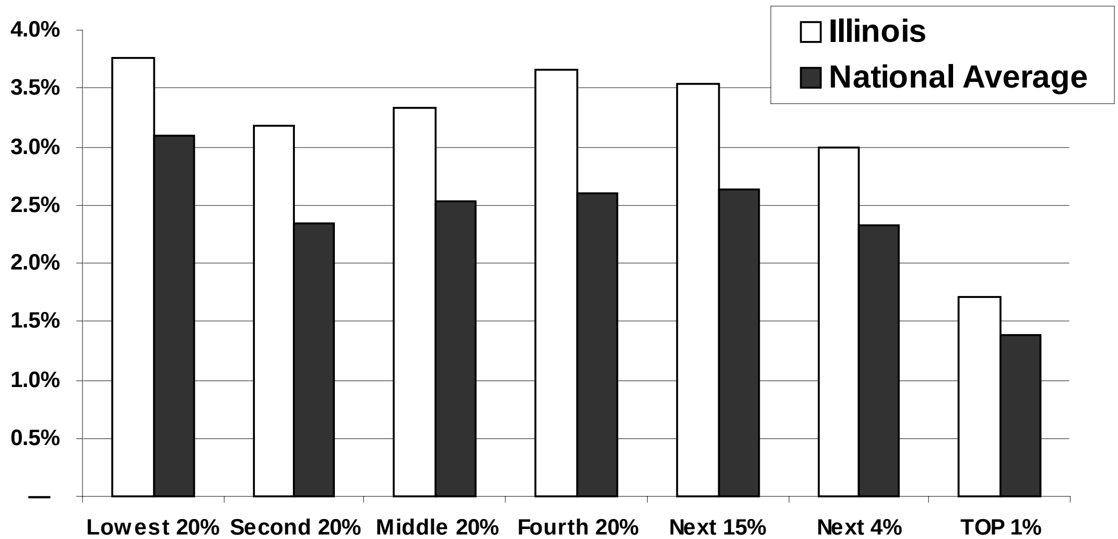
The Illinois Earned Income Tax Credit (EITC). The Illinois EITC was established in 2000 and designed to piggyback on the much larger and refundable federal EITC, established in 1975 as targeted tax relief for low-income working families. The state EITC offered an income tax credit equal to 5 percent of the federal credit, up to a family's income tax liability. In 2003, as the legislation was set to expire, Illinois policymakers made the state EITC both permanent and "refundable".

The new refundability provision allows a family to get the full value of the credit even if its income tax liability is less than the amount of the credit. This element of the law's reauthorization is key because, although a low-income family may not earn enough to owe state income tax, that family still faces a disproportionate tax burden in property, sales and excise taxes and the credit can now serve to offset these taxes as well.

Property Tax in Illinois

Property taxes in Illinois are regressive – those with lower incomes generally pay more in property taxes as a share of income than do those with higher incomes. The property tax is the largest single tax in Illinois and residents pay more of their income in property taxes than do the residents of other states. In fact, property tax burden in Illinois is growing while, for the nation as a whole, it has declined.

Illinois Property Tax Compared with National Average (2002) as share of family income by income group for non-elderly taxpayers



Source: Institute on Taxation and Economic Policy

Property tax credits designed to relieve some of this burden are generally not well targeted and do not provide the relief to those who need it the most. Property tax credits are limited to those who own property even though renters bear property tax burden in the form of higher rents. Also, because the property tax credit is claimed against state income taxes and is non-refundable, only individuals with income tax liability are eligible for the credit. Because the Illinois income tax does not make up a significant part of the tax burden for low-income taxpayers, it is not uncommon for a family to have little or no income tax liability but still face a high property tax burden. The non-refundability, therefore, makes these taxpayers unable to take advantage of the full value of the credit.

Property Taxes and Education. Illinois relies heavily on local property tax revenue to fund public schools. Illinois ranks 48th out of the 50 states in its share of state funding for public schools[4]. Over-reliance on the property tax to fund elementary and secondary education in Illinois has important equity implications. Because the state relies so heavily on local property taxes, disparities in property tax wealth from one school district to another – ranging from a low of less than $10,000 to well over $1 million in “tax base” per pupil[5] – lead to wide variations in per pupil spending across these districts. This poor showing earned Illinois an ‘F’ in equity on Education Week’s “Quality Counts 2003” report. Increasing the state share of education funding while reducing the reliance on the property tax would help to break the link between where a child lives and the quality of the education that child receives.

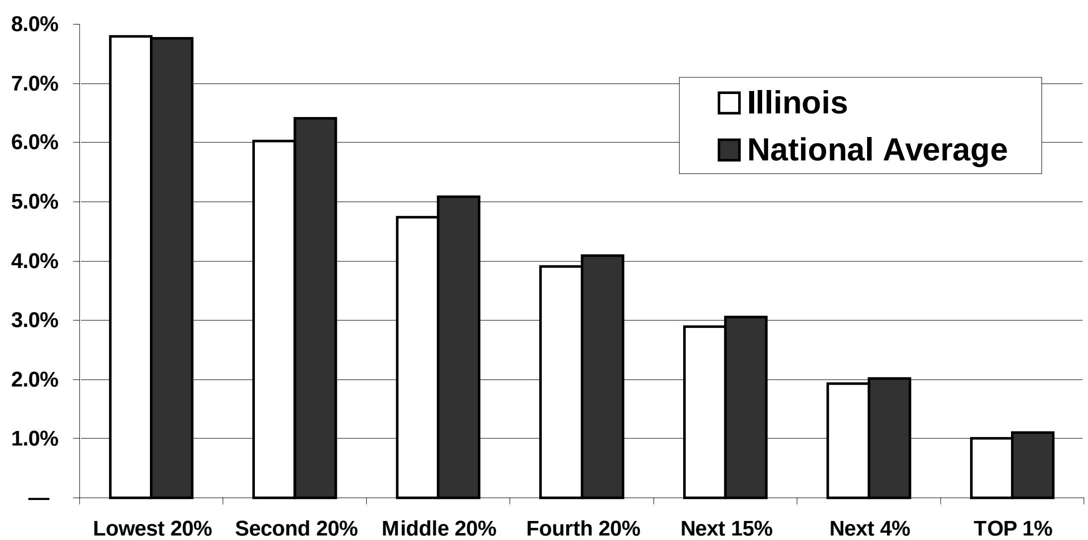
[4] Source: U.S. Bureau of the Census, Governments Division, 2001
[5] Illinois State Board of Education data

Illinois Sales and Excise Taxes

The overall sales tax burden facing Illinois families is slightly less than that of most states. While the state's sales tax rate is relatively high, many items are exempt from the sales tax. For example, the Illinois sales tax exempts most sales of personal, professional and business services. The revenue-generating ability of the Illinois sales tax has diminished over time as this narrow tax base does not adequately reflect the Illinois economy in which the service sector is growing rapidly. Furthermore, Illinois relies more heavily on ***excise taxes*** – levied on a specific type of good or service such as cigarettes, gasoline, and alcoholic beverages – than do other states.

Illinois sales and excise taxes are the most regressive of its major revenue sources. Because low-income families spend more of their incomes on items subject to sales and excise taxes while the wealthy are more able to save, these taxes affect low-income families disproportionately. In fact, low-income families in Illinois pay nearly eight times as much of their income in these consumption taxes as do the wealthiest.

Illinois Sales and Excise Taxes Compared with National Average (2002) as share of family income by income group for non-elderly taxpayers



Source: Institute on Taxation and Economic Policy

Recommendations

There are a number of reforms that can help to improve both fairness and stability in the Illinois tax system and make our state better able to support important services for children and families:

- **Increase reliance on the income tax while decreasing reliance on the property tax.** The income tax is the only major component of the Illinois tax system that is even slightly progressive and shifting reliance to the income tax will improve overall equity in the system. Increasing the income tax will also bring Illinois more in line with the states' average as our income tax currently lags far behind. Decreasing reliance on the property tax will also move Illinois closer to the national norm as the state property tax burden is higher than that of other states. Perhaps most importantly, increasing reliance on the state income tax while decreasing reliance on the property tax will help to break the link between where a child lives and the quality of education that child receives.

- **Increase the value of the Illinois Earned Income Tax Credit.** Illinois' EITC has provided help to hundreds of thousands of working families and the recently added refundability will make it available to an additional 150,000-200,000 working families. It has significantly raised the ***state income tax threshold*** – the income level at which a family must pay income tax. Nevertheless, more needs to be done. Unlike most other states, the level at which Illinois begins taxing a family's income is still thousands of dollars below the federal poverty guidelines. Several states also offer a much more generous state credit. Expanding the Illinois EITC from 5 percent of the federal credit to 20 percent of the federal credit will further help to increase the state income tax threshold and counteract the unequal tax burden faced by low and middle-income Illinois working families.

- **Transform the property tax credit to help those most in need.** Currently, Illinois only allows homeowners to claim a property tax credit while the property tax burden gets passed on to renters as well in the form of increased rent. Allowing renters to claim this credit will help to offset the regressivity of the property tax. Further, because an Illinois family claims the non-refundable property tax credit against that family's income taxes, the full value of the current credit is unavailable to those with little or no income tax liability. Making this credit both available to renters and making it refundable will help to offset regressivity in the overall system.

- **Widen the state's narrow sales tax base to include more services and adopt a sales and excise tax credit for low-income families.** While Illinois' consumption taxes are clearly its most regressive, these taxes are vitally important for generating revenue. These taxes are especially crucial in difficult economic times as spending on items subject to the sales tax remains relatively constant. Including services in the sales tax base will help to offset the regressivity of these taxes as those that are better off are more likely to spend their money on services. Additionally, including services will result in generating new revenue into the future, as the service sector is a rapidly growing piece of the economy. In combination with these base-broadening recommendations, more needs to be done to offset the inherent regressivity of sales and excise taxes in Illinois. Adopting a refundable sales and excise tax credit, like the state earned income tax credit, is one way to reduce the disproportionate tax burden facing low-income families in Illinois.

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