Ready, Set, Reform

How the Income Tax Can Help Make the Illinois Tax System Fairer and More Sustainable

Institute on Taxation and Economic Policy

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EXECUTIVE SUMMARY

- The state of Illinois faces a large budget deficit, with a projected gap between revenues and spending needs exceeding $11.6 billion over the next two fiscal years. The state also faces a long-term *structural* deficit—a mismatch between the state's spending needs and the revenues available to fund those needs.

- Illinois also faces a chronic tax fairness crisis, with one of the most unfair tax systems in the nation. Low-income families pay more than twice as much of their incomes in Illinois taxes than do the wealthiest Illinoisans.

- Each of these crises can be traced to inadequacies in the state's personal income tax, which is among the lowest and least progressive in the nation.

- Fortunately, there is a growing consensus among elected officials, including Governor Quinn, that a more progressive income tax should be the cornerstone of any effort to resolve the state's budget dilemma in 2009.

- Simply increasing the income tax rate will go a long way towards closing the state's budget deficit—but lawmakers should also take steps to mitigate the impact of such an increase on middle- and low-income families. Options for doing so include exemptions, deductions, and a "tax forgiveness credit."

- The income tax doesn't have to be the only answer for Illinois. Income tax increases can usefully be supplemented with reforms in other taxes—especially the sales tax and the property tax—in ways that further achieve the sustainability and tax fairness goals that all Illinoisans share.

- Refundable tax credits, including the Earned Income Tax Credit but also possibly including new credits to offset sales tax or property tax liability, could help to make the Illinois tax system somewhat less unfair.

- A sensible combination of the reforms outlined in this paper would raise at least $3.6 billion if implemented in tax year 2008, while cutting the taxes paid by the poorest sixty percent of the Illinois income distribution substantially. This option would also result in a federal tax *cut* of $900 million for Illinoisans.

Introduction

The Illinois tax system faces a crisis of both adequacy and equity. The state must confront a projected $11.6 billion budget shortfall over the next two fiscal years that will likely require a variety of difficult spending and tax policy choices, and also faces a fundamental long-term mismatch between its spending needs and the revenues available to fund those needs. The Illinois tax system is also chronically unfair, imposing much higher tax rates on middle- and low-income families than on the best-off Illinoisans.

A revitalized state personal income tax is the best tool available for resolving these twin crises. Alone among the major taxes levied by states, the income tax applies a higher rate to the upper-income taxpayers whose incomes are growing the fastest. Increasing the Illinois income tax—currently one of the lowest and least-fair such taxes in the nation—will restore a modicum of fairness to the state's tax system while helping to ensure that state revenues are sufficient to fund public services in the upcoming fiscal year and in the long run.

For years state lawmakers have relied on gimmicks to balance the state budget, thus forming the foundation of the current crisis. Fortunately, there is a new willingness among many policymakers, including Governor Pat Quinn, Cook County Assessor Jim Houlihan, and Senator James Meeks, to build sound tax reform strategies around a stronger income tax, and legislation that would increase the income tax has found growing support in recent years.

This paper begins by describing the imbalances in the state's current tax system, and examines the proper role of the personal income tax in a fair and sustainable tax system. We then describe options for income tax reform, with an eye toward revenue-raising and fairness-enhancing objectives. The report also offers a brief overview of productive non-income-tax reform options, and presents a simple package of tax reforms that would offer substantial improvements to the fairness and yield of the current tax system.

The Illinois Tax System: Unbalanced and Unfair

Illinois is not a high-tax state: in fiscal year 2006, Illinois state and local taxes were 10.9 percent of statewide personal income, well below the U.S. average of 11.3 percent.[1] But this statistic conceals a remarkable imbalance between different types of Illinois tax: some Illinois taxes are especially low, while others are especially high. Illinois property taxes are actually more than 20 percent above the national average as a share of income, while Illinois personal income taxes are almost 30 percent below the national average by this measure.

This under-reliance on income taxes is directly responsible for a second type of imbalance in the Illinois tax system: more so than most other states, Illinois imposes much heavier taxes on its middle- and low-income families than on upper-income taxpayers.

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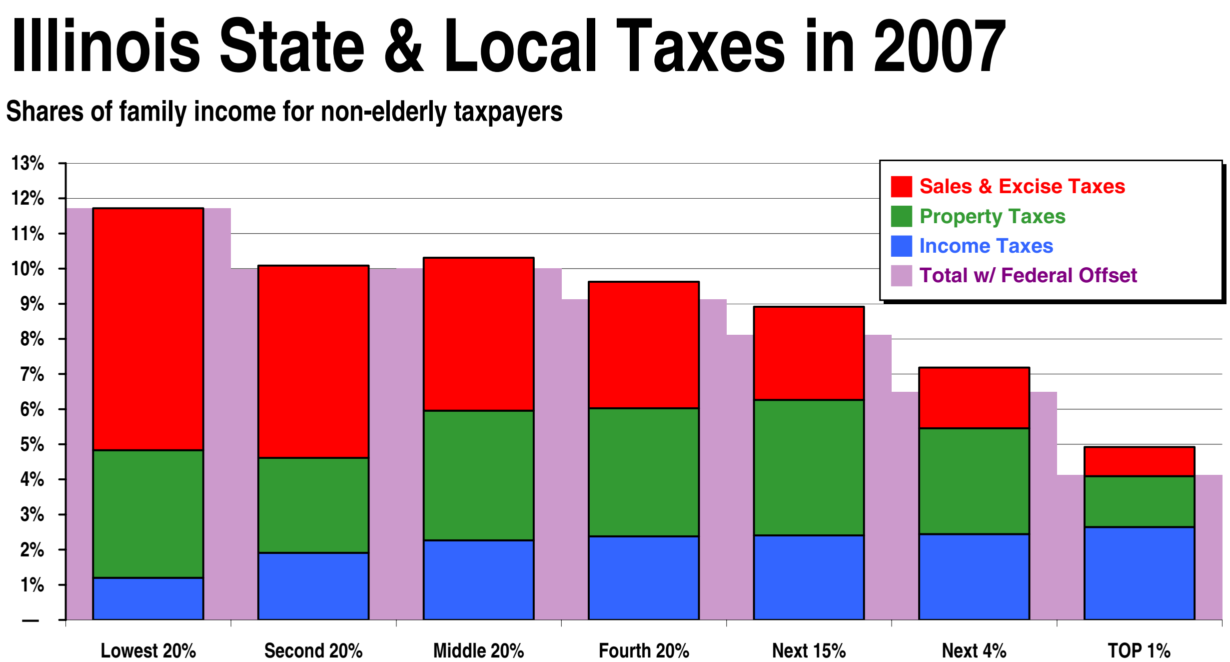
[1] 2006 is the latest year for which the U.S. Census Bureau has published 50-state data on tax collections.

The graph on this page shows state and local taxes as a share of personal income for each Illinois income group. In 2007, the poorest 20 percent of Illinois residents (those with incomes less than $9,700) paid 11.7 percent of their income in Illinois taxes. Taxpayers in the middle 20 percent of the Illinois income scale, with average incomes of $44,900, paid 10 percent of their income in Illinois taxes. The richest 1 percent of Illinois residents—with average incomes of $1.9 million in 2007—paid 4.1 percent of their income in Illinois taxes.

Put another way, the Illinois tax system requires low-income families to pay about twice as much of their income in taxes as the best-off Illinoisans must pay.



Virtually every state's tax system follows the same broad pattern of unfairness—although most are less unfair than the Illinois tax system. This nationwide pattern of unfairness is the result of the interaction between three broad types of taxes:

- Sales and excise taxes fall very heavily on low-income families, and have little impact on upper-income families.
- Property taxes are less regressive, but still fall more heavily on low- and middle-income families than on the best-off taxpayers.
- Personal income taxes generally are less burdensome for low-income families, and apply higher tax rates on upper-income families.

The Illinois tax system is among the most regressive in the country because of two distinctive features of its tax system:

- The state relies more heavily on regressive local property taxes than most other states;
- The Illinois income tax is especially low and flat—which makes it harder for the income tax to offset the unfairness of sales and property taxes than in most other states.

How Tax Fairness Affects Sustainability

No state's tax system is immune from short-run budget deficits. But in the long run, some tax systems are simply better-equipped than others to adequately fund public services. The basic test of a sustainable tax system is this: does its tax revenue grow as fast as the cost of the public services it's supposed to pay for?

A report by the Center on Tax and Budget Accountability finds that the Illinois tax system fails this test. The CTBA estimates that, even after factoring out the state's short-term budgetary woes, there is an underlying long-term gap between state and local public spending and revenues that is growing over time.[2] This means that, if the tax system is not changed, it will become even more difficult over time to balance the state's budget.

This result shouldn't be surprising: when states like Illinois choose to fund public investments using an especially regressive tax system, they are essentially trying to raise money from the people who have the least of it. The wealthiest 1 percent of Illinoisans have more income than the poorest 60 percent put together. And the best-off 20 percent of Illinoisans make more than the remaining 80 percent combined—so balancing a tax system on the backs of the poor simply does not yield much revenue compared to modest taxes on the best-off families.

This flaw in the Illinois tax system has been compounded in recent years: wealthy Illinoisans have gotten much richer, while everyone else has gotten squeezed. The richest 1 percent of Illinois families saw their inflation-adjusted average incomes rise by 53 percent between 1988 and 2008. Meanwhile, middle-income earnings grew by 10 percent, and the poorest 20 percent saw their real incomes actually decline by 1 percent over this period.[3]

States seeking to ensure that their state tax collections keep pace with income growth—and with the cost of funding public services—have one important tool at their disposal: the progressive personal income tax. Yet, as we shall see, Illinois has essentially chosen to leave this tool in the toolbox. As a result, the upper-income families who have enjoyed the fastest growth in personal incomes continue to contribute the least to Illinois' coffers.

How the Illinois Income Tax Falls Short

Uniquely among the major taxes levied by state governments, the personal income tax can be designed to ensure that the best-off families pay a moderately higher share of their income in tax than middle- and low-income families—and to ensure that income tax revenues will grow at a rate sufficient to fund public investments over time.[4] But the Illinois income tax simply doesn't achieve these goals. One academic study found that the long-term growth rate of the

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[2] *Private Sector Job Trends and the Illinois Structural Budget Deficit*, Center on Tax and Budget Accountability, January 2007. Accessed at www.ctbaonline.org.

[3] Institute on Taxation and Economic Policy Microsimulation Model, April 2009.

[4] Of course, even the most progressive income taxes (like that of California) are not enough to make state taxes progressive overall. The best-off Californians still pay less of their income in California taxes than do the worst-off California families.

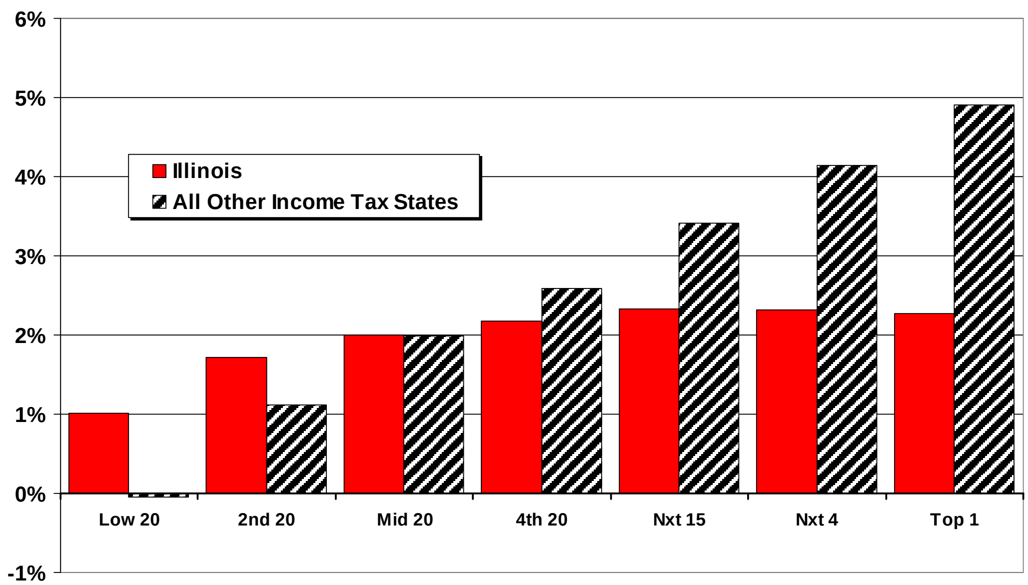
Illinois income tax was the lowest in the nation between 1976 and1995.[5] By choosing to rely more heavily on sales and property taxes, Illinois policymakers have essentially decided to leave their most effective tax on the sidelines.

Why is the Illinois income tax so ineffective? In a nutshell, it's because the tax is especially low and is virtually flat. The state's 3 percent tax rate is the lowest top tax rate in the U.S. And of the 41 states that levied broad-based income taxes in 2006, only four states' income tax collections were lower, as a share of state personal income, than Illinois.

The state's income tax is also, bar none, the least fair income tax in the nation, according to an ITEP analysis. No other state requires low- and middle-income families to carry as much of the income tax load as does Illinois. The chart on this page, based on an ITEP analysis, shows how the Illinois income tax stacks up to that of every other state:

- Low-income Illinoisans pay substantially more of their income in state income tax than do residents of other states. In fact, on average, the poorest quintile of families in other states are essentially exempt from owing income taxes.
- Upper-income Illinois taxpayers pay substantially less of their income in state income taxes than do similar families in other states.
- This gap between Illinois and other states is largest for the top 1 percent of the income distribution: Illinois income taxes on this group are less than half the national average.

Income Tax As % of Income, Illinois compared to All Other Income Tax States



Three distinct flaws in the Illinois income tax lead to this unfair result: the single flat tax rate, the lack of a meaningful "no-tax floor," and the lack of a generous refundable low-income tax credit.

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[5] Dye, Richard F., and Therese J. McGuire, 1998. "Block Grants and the Sensitivity of State Revenues to Recession."

A Flat Tax Rate

Illinois is one of only seven states that apply a single tax rate to the income of the poorest and richest taxpayers. The choice of a flat-rate tax is problematic for several reasons. First, by taxing the income of the wealthiest taxpayers at the same rate as the poorest workers, a flat-rate tax ignores the important difference in ability to pay between poor and wealthy taxpayers. Second, because high-income taxpayers tend to enjoy the fastest income growth, and because flat-rate taxes rely less on these wealthiest taxpayers than do graduated-rate income taxes (which apply higher tax rates to higher-income taxpayers), flat-rate income taxes tend to grow more slowly than graduated taxes. Third, flat-rate taxes do not take full advantage of the ability of upper-income taxpayers to export part of their income tax bill to the federal government (see text box below).

> **How State Income Tax Hikes Can Cut Your Federal Taxes**
>
> For many upper-income Illinoisans, part of any state income tax hike they face will ultimately never come out of their pockets at all. Illinoisans who itemize deductions on their federal tax returns are allowed to write off the Illinois income taxes they pay—which directly reduces their federal tax bill. For every dollar in income taxes paid to the state of Illinois, taxpayers who itemize get an offsetting federal tax cut of as much as 35 cents. By contrast, a dollar of income taxes paid by lower-income Illinoisans who aren't as likely to itemize will, in the end, fall entirely on these Illinois residents.
>
> This means that Illinois policymakers can choose what percentage of a state tax hike should be paid for by the federal government. The more progressive the income tax hike, the greater the share of the bill that will be paid through federal income tax reductions.

Implementing a graduated income tax rate structure would immediately make for a more sustainable and fair tax system. Yet, like most of the states currently levying flat-rate personal income taxes, Illinois has entrenched its flat tax rate in the state constitution, which means that the most effective way of making the income tax more progressive—enacting a graduated rate structure—would require a constitutional amendment. The good news is that there are a number of straightforward ways in which Illinois lawmakers could increase the flat tax rate in a way that would make the impact of the state income tax quite similar to that of a graduated tax system. A discussion of ways to make the state's income tax more progressive without running afoul of constitutional restrictions follows.

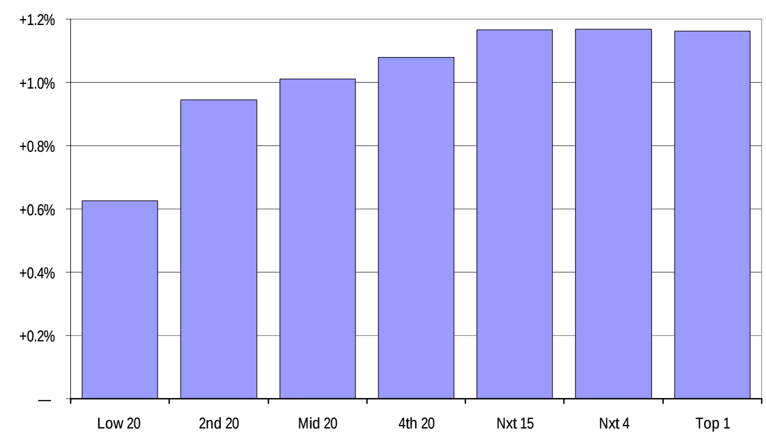
Low-Income Exemptions and Deductions

Every state's income tax allows low-income taxpayers to shelter a certain amount of income from tax, setting a floor below which low-income taxpayers will owe no income tax. This is most frequently done by allowing exemptions, which shield a set amount of income from tax for each member of a family. Many other states provide additional means of providing a "no-tax floor," including:

- **Standard deductions.** Used by the federal government and many states, a standard deduction provides a basic no-tax floor for each type of family; unlike exemptions, the deduction's value does not increase for larger family sizes.
- **Poverty tax credits.** Some states allow a tax credit designed to reduce income taxes to zero for any family below the poverty line. Pennsylvania's "tax forgiveness" credit, gives a married couple earning $13,000 or less a tax credit equal to 100 percent of income tax liability. This income limit is expanded by $9,500 for each child, so that a married couple with two children pays no income tax on the first $32,000 of income. The credit percentage is gradually reduced to zero above these income limits.

Illinois allows an exemption for $1,000 for each family member—so that a married couple with two children see their first $4,000 of income exempt from tax as a result—and has no standard deduction or poverty credits at all. Most other states provide more generous low-income exemptions and deductions: as a result, more of poor families' income is subject to tax in Illinois than in most other states. A study by the Center on Budget and Policy Priorities found that for a two-parent family of four, the 2007 tax threshold—the amount of income that is shielded from taxation through deductions, exemptions and credits—was lower in Illinois than in all but six other states. The report also found that Illinois was one of only fifteen states that required two-parent families of four earning less than the poverty level to pay income taxes in 2007.[6]

Impact of Simple Income Tax Rate Increase
Tax Change as % of Income, All Illinoisans in 2008



Increasing the state income tax rate will, taken on its own, increase taxes in a progressive way, as the chart on this page shows. But such a move will also increase taxes on all current income taxpayers—even those living well below the poverty line. For this reason, any revenue-raising tax reform should include some provision to ensure that families living below the poverty line will be sheltered from the effects of this tax change.

One sensible approach would be to increase Illinois' comparatively low exemptions. The downside of this approach is that increased exemptions would provide tax cuts not only to at-risk, low-income families, but even to the wealthiest Illinoisans. Put another way, increasing the per-person exemption from $2,000 to (for example) $6,000 reduces taxable income by the same $4,000 amount for a minimum-wage worker and a well-paid stockbroker.

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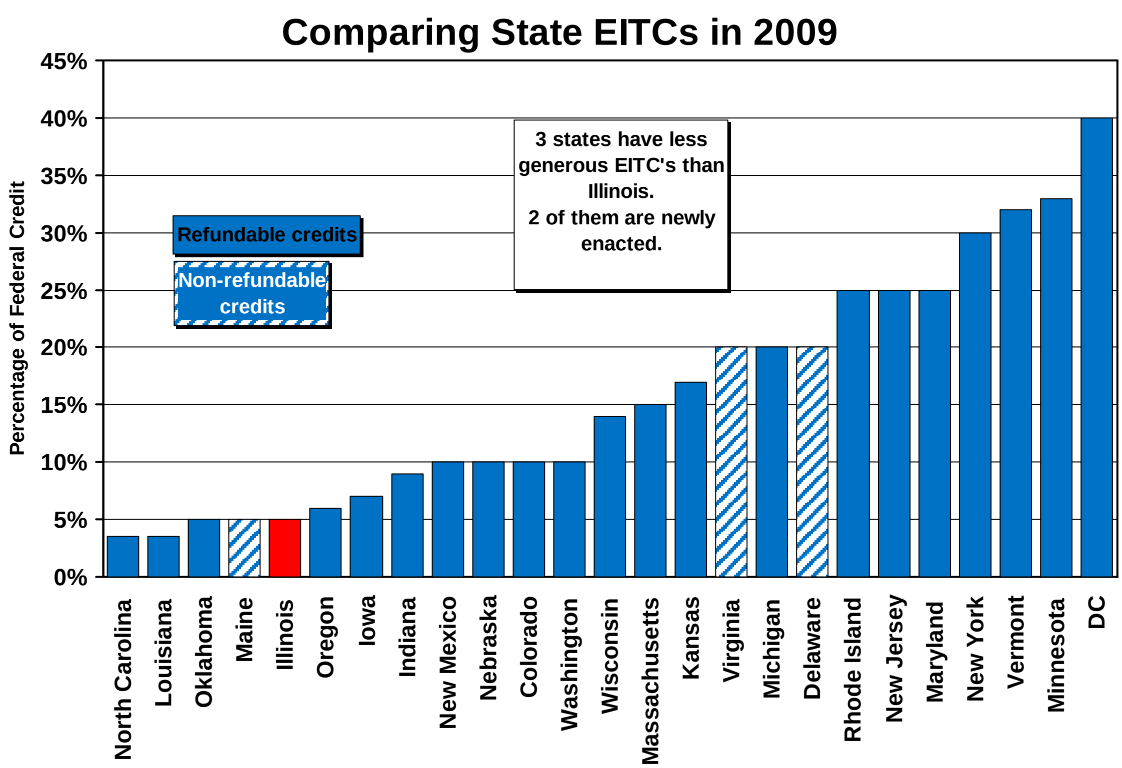
[6] Levitis, Jason A. and Nicholas, Andrew C, *The Impact of State Income Taxes on Low-Income Families in 2007,* The Center on Budget and Policy Priorities, Washington DC, October 29, 2008.

By contrast, the "poverty credit" approach outlined above can be used to shelter low-income families from tax at a much lower cost. In a fiscally challenging environment, such an approach could better achieve the twin goals of revenue-raising and tax fairness.

Refundable Tax Credits: An Important Tool for Tax Fairness

For many low-income Illinoisans, the personal income tax is less burdensome than the sales, excise and property taxes levied by state and local governments. While the "poverty credit" approach outlined above can be vital in reducing the impact of income tax changes on low-income families, it can do nothing to offset the impact of sales and property taxes.

This is one reason why many states (and Illinois) have chosen to enact at least one refundable tax credit—a credit that, while usually administered on income tax forms, can be used to offset any of the taxes paid by low-income families. Illinois is one of twenty three states (plus the District of Columbia) that achieve tax relief for the working poor with an Earned Income Tax Credit (EITC) based on the federal credit of the same name. The credit is designed to provide targeted tax relief to low-income working taxpayers, because it is calculated as a percentage of earned income.



One important feature of the Illinois EITC is that it is refundable—meaning it is available even to those low-income households without income tax liability. Because of this, the EITC can help offset the regressive sales and excise taxes paid by low-income taxpayers.

But the Illinois credit has important limitations. First, it is only 5 percent of the federal credit, which makes it among the smallest EITC's in the nation. (By comparison, Michigan recently enacted a 20 percent EITC—four times as generous as the Illinois credit.) Second, the EITC provides little benefit to low-income single workers without children, and offers no benefit at all to retirees. Each of these groups are typically hit hard by sales and property taxes.

One intriguing complement to the EITC is a refundable "sales tax credit" of the sort adopted in a number of states in recent years. For example, Kansas allows low-income families with children to claim a tax credit of up to $80 per family member to offset the impact of the sales tax on food.[7] The credit is claimed on income tax forms, but does not depend on income tax liability at all. A similar, but much more generous, tax credit has been part of several prominent tax reform bills introduced recently in Illinois.[8]

Beyond the Income Tax: Other Options for Tax Reform

The income tax isn't the only available option for improving the Illinois tax system, of course. Each of the other major state and local taxes levied by Illinois could be reformed in a way that could make these taxes fairer and more sustainable. This section discusses three options—expanding the state sales tax base, eliminating corporate tax loopholes and revamping the state's system of property tax credits—that could productively added to any broad Illinois tax reform measure.

Revamping An Outdated Sales Tax Base

Illinois, like most states, applies its sales tax primarily to goods, like books or televisions, and exempts personal services such as haircuts or landscaping. In doing so, Illinois policymakers are unwittingly exempting the fastest-growing part of retail spending from the state's tax base. Continuing to exempt services will eventually make the state sales tax increasingly irrelevant as a funding source. Of course, any sales tax base expansion will increase the role of a regressive tax, so the impact will be felt most keenly by the low-income families hit hardest by the current tax system. For this reason, any sales tax base expansion should be accompanied by a generous refundable tax credit of the sort discussed in the previous section.

Eliminating Corporate Tax Loopholes

The Illinois corporate tax is being gradually eroded by a variety of tax breaks and tax avoidance schemes. Illinois allows a special tax break for manufacturers known as the "single sales factor" that puts small businesses at a disadvantage relative to multi-state companies and depresses corporate tax collections. Repealing this and other corporate tax giveaways could help ensure that the most profitable corporations pay their fair share.

Reforming Poorly-Targeted Property Tax Breaks

Illinois currently spends more than $500 million a year on a single tax break: an income tax credit equal to 5 percent of homeowner property tax bills, that manages to give the biggest

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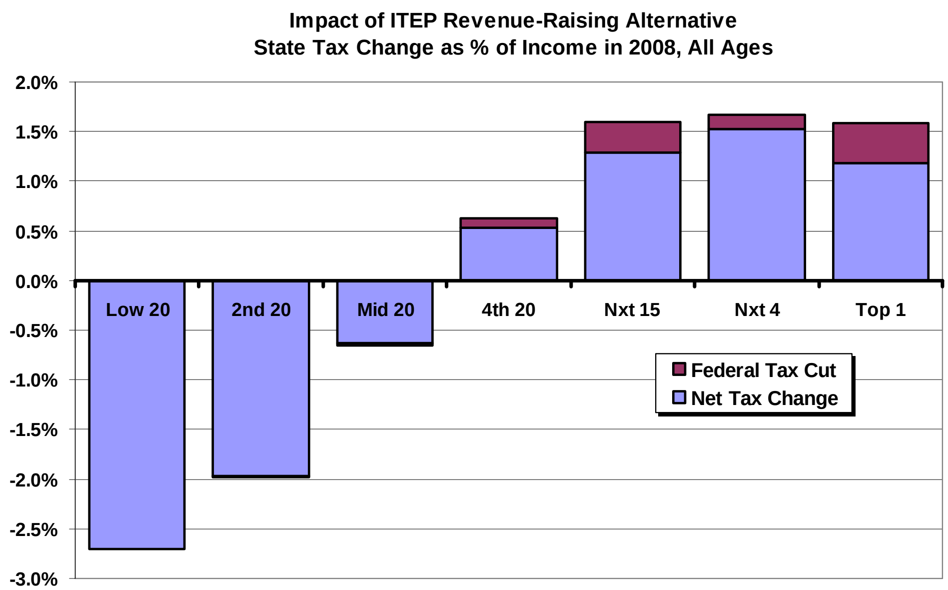
[7] Kansas also allows a state Earned Income Tax Credit, reflecting the complementary nature of these credits.
[8] For example, Illinois Senate Bill 750 of 2008 would have introduced a "Family Tax Credit" designed to offset the impact of income and sales tax hikes on most low- and middle-income families.

tax breaks to better-off families while offering nothing at all to low-income homeowners and renters. The state also offers a more targeted "circuit breaker" style property tax rebate (so called because the credit is designed to be available only to taxpayers whose property tax bill overloads their capacity to pay it) to senior citizens. Low-income seniors can claim a tax credit for the amount by which their property taxes exceed 3.5 percent of their income. Since renters are generally understood to pay property taxes indirectly in the form of higher rents, elderly renters are allowed to assume that 25 percent of their rent constitutes property taxes for purposes of this credit.

One straightforward approach to inexpensive, targeted property tax relief would be to repeal the 5 percent property tax credit and use the revenue to extend eligibility for the Illinois "circuit breaker" credit to non-elderly homeowners and renters. Under this plan, low- and middle-income Illinois homeowners would qualify for a property tax credit if their property tax bills exceeded 3.5 percent of their incomes. Renters would qualify for similar assistance if 25 percent of their rent exceeded this threshold.



Putting It All Together: A Progressive Revenue-Raising Plan

This section lays out a combination of income tax reforms that would raise over $3.6 billion in new state revenue if implemented in tax year 2008.

Recognizing that the bedrock of any major tax reform effort should be an increase in the importance of the state's personal income tax, the plan outlined here is built around an increase in the state's personal income tax rate from 3 percent to 5 percent. The impact of the income tax increase on low- and middle-income families is mitigated by an expansion of the state's Earned Income Tax Credit to 15 percent and the introduction of a new "tax forgiveness credit" designed to ensure that the income tax doesn't push low-income Illinoisans further into poverty.

This plan also moves beyond the income tax by repealing the 5 percent property tax credit and creating an all-ages "circuit breaker" property tax rebate designed to extend the benefits of the current elderly circuit breaker to low-income homeowners and renters of all ages.

The chart on the previous page shows the impact of this plan on taxpayers at different income levels. Among the notable results are that:

- The poorest sixty percent of the Illinois income spectrum would, on balance, see its taxes go down under this plan.
- The biggest tax cuts, as a share of income, would go to the very poorest Illinoisans—those hit hardest by the current tax system.
- Families in the middle of the Illinois income spectrum would see their taxes go down, on balance, as well.
- While many upper-income Illinoisans would see their state taxes increase under this plan, a substantial amount of the tax hike would ultimately be paid by the federal government in the form of lower federal taxes for Illinois itemizers. Fully 25 percent of the added tax revenue going to Illinois coffers under this plan would be taken not from the pockets of Illinois families but from the federal government. In tax year 2008, this would mean a $900 million federal income tax cut for better-off Illinoisans.

This set of reforms would go a long way toward eliminating the state's budget deficit in the short run, and would also represent an important step toward tax fairness—although the Illinois tax system would remain regressive overall even if these reforms were adopted wholesale.

The specific package of options chosen here is designed to achieve a combination of fairness-enhancing and revenue-raising goals. Of course, there is no "right" balance between these two goals: at one extreme, lawmakers could simply increase the income tax rate to 5 percent and use all the revenue (close to $5 billion in 2008) to meet spending needs. At the other extreme, lawmakers could use every dime of the revenues from increasing the rate to reduce taxes on middle- and low-income families. The option described here is only one example of a package of options that falls in the midrange of these goals.

As previously noted, while the income tax is the most sensible starting point for revenue-raising reforms, policymakers would do well to consider non-income tax reforms as well. The estimated $3.6 billion yield of the tax plan described here could be augmented substantially by expanding the state sales tax to include more services and goods, and by eliminating corporate tax loopholes.

Conclusion

After more than a decade of inaction, Illinois policymakers are, at last, increasingly recognizing that strengthening the state's personal income tax must be a focal point in any effort to balance the state's budget without unduly burdening middle- and low-income families. The failings of the state's current income tax, documented in this report, give lawmakers an important opportunity for straightforward and reasonable tax changes that enhance the yield and fairness of the tax system.

However, while raising the state's income tax rate is a sensible cornerstone for revenue-raising tax reform, steps should also be taken to mitigate the impact of these tax increases on middle- and low-income families. Expanding the state's Earned Income Tax Credit and increasing the "no-tax floor" would help ensure that the fixed-income families hit hardest by the current tax system wouldn't be pushed further into poverty by income tax reform.

Finally, it's important to remember that while the income tax is a sensible starting point for reform, other taxes can be tailored as well in a way that will help avoid structural deficits. Sales tax base broadening and better targeting of property tax credits would each make the Illinois tax system fairer and more sustainable.

About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes.* ITEP's full body of research is available at www.itepnet.org.