

# Balancing Act Tax Reform Options for Illinois

Matthew Gardner  
Robert G. Lynch  
Richard Sims  
Ben Schweigert  
Amy Meek

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**Institute on Taxation and Economic Policy**  
1311 L Street, NW • Washington, D.C. 20005 • (202) 626-3780

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# BALANCING ACT

## TAX REFORM OPTIONS FOR ILLINOIS

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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 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 on the state's tax structure to date, and plan sensible long-term revenue-raising strategies.

This report assesses the Illinois tax system as it affects taxpayers at different income levels. 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 on property taxes, combined with the state's relatively low reliance on income 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 income.

By balancing the tax system 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 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

### Economic and Social Indicators

After a period of slow growth in the 1980s, the Illinois economy has rebounded in recent years. Yet there are indications that the state's economy has not recovered all of the ground that it lost during the 1980s. And many of Illinois's citizens did not share in the prosperity of the 1990s: the state continues to perform poorly on basic indicators of social well-being such as infant mortality, child poverty and health insurance coverage. Only a willingness to make further public investments in health, education and infrastructure can ensure that Illinois will remain an attractive location for taxpayers and businesses.

### 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 slightly below the national average, ranking 31<sup>st</sup> nationally.
- On a per capita basis, Illinois taxes are slightly above the national average, ranking 15<sup>th</sup> nationally—and are second highest among neighboring states.

However, measuring tax burdens as a percentage of income is a more accurate measure of tax burdens because it takes account of a state's overall ability to pay taxes. By this measure, state and local taxes in Illinois are slightly below the national average, ranking 35<sup>th</sup> in the nation—lower than all but one surrounding state.

Illinois relies more on taxes—and less on non-tax revenues 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 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:

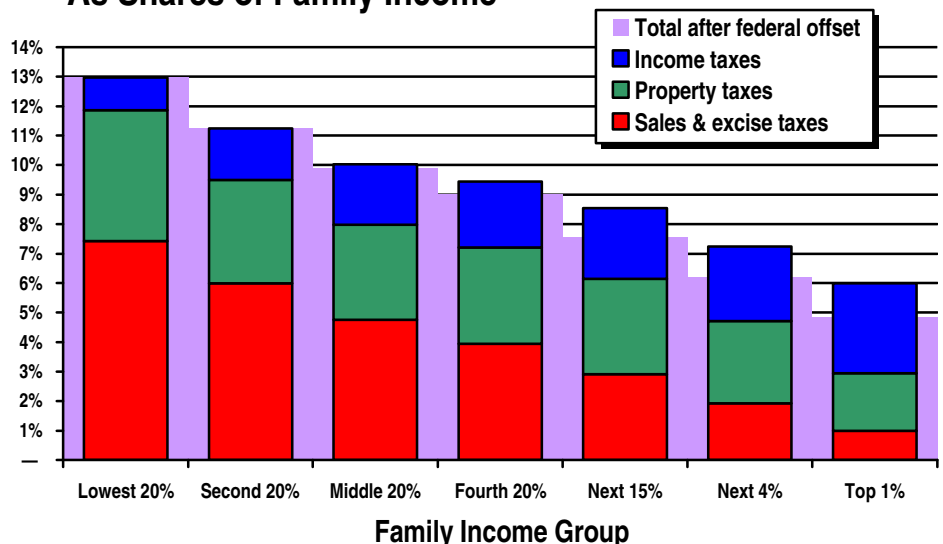
- The poorest fifth of all Illinois taxpayers, with incomes of less than \$15,000 per year, pays 13.8 percent of its income in total Illinois taxes.
- Families in the middle of the income scale pay 10.4 percent of their income in Illinois taxes.
- The wealthiest one percent of Illinoisans, with an average income of \$1.2 million, pay only 8.4 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

**Illinois State and Local Taxes in 2000  
As Shares of Family Income**



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 even 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.

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 less visible—and more regressive—tax hikes over the course of the decade, due to the effects of inflation on income and property tax relief mechanisms and due to the gradual increase in local sales tax rates across the state.

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 income tax burden on the very poorest taxpayers is among the highest in the nation. And although slightly progressive, 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 one 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 cred-

it. 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 exempts all Social Security income, including the portion that is federally taxable. This exclusion is regressive and costly: the wealthiest 10 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 (EITC) based on the federal credit. Yet the Illinois credit is one of the smallest currently allowed by states—and its nonrefundability limits its value for low-income taxpayers.

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—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. 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 eighth most regressive 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 neighboring states have also enacted similar legislation, the incentive effect of the single sales factor in Illinois will be minimal—although the loss in state tax revenue will be substantial.

Moreover, the single sales factor singles out certain corporations for preferential tax treatment—those that make most of their sales out of state—while *increasing* the tax burden on firms that make most of their sales in Illinois. This arbitrary treatment means that firms with different sales patterns but

identical profits can have very different tax burdens—which undermines the perceived equity of the tax system.

In addition, the state corporate income tax base is reduced substantially by existing tax breaks such as the research and development tax credit and the net operating loss deduction. Corporate tax breaks in fiscal year 2000 amounted to 14 percent of total corporate tax collections.

The Illinois corporate income tax also faces external pressures. Because the tax is based on federal corporate income definitions, growing federal corporate loopholes have eroded the state's corporate income tax base (and newly enacted corporate loopholes will make things even worse in the future). Unfortunately, the information that would allow researchers to analyze the impact of federal tax breaks on Illinois-based corporations is not currently available for *state* income taxes. As a result, it is difficult to know whether the resurgent problem of zero-tax corporations on the federal level, documented in an October 2000 ITEP study, is threatening the Illinois corporate tax base as well. Illinois lawmakers should take steps to ensure that profitable Illinois corporations are paying their fair share by allowing lawmakers and the public to know the impact of state tax breaks on individual corporations.

## Tax Reform Options

In the current economic climate, there is increasing pressure on Illinois legislators to shore up the income, sales and property tax base—and to raise tax rates. Chapter Seven of this report presents thirty detailed tax-change options for 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 offsetting the impact of progressive income tax increases—and in reducing the effectiveness of high-end income tax cuts. For the wealthiest taxpayers, close to 40 percent of the state revenue losses from 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. For these same taxpayers, close to 40 percent of income tax *increases* will be paid by the federal government—not by Illinois taxpayers.

- 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, conversely, that every dollar of any sales tax cut 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.

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 fifth 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 next table 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.

## NOTES ON PRESENTATION

The distributional tables in this report were produced using the Institute on Taxation and Economic Policy Microsimulation Tax Model. The tables look at Illinois taxpayers by income levels and when relevant, by family type and age. The following table shows the relative importance of these demographic groups in 2000.

- 54 percent of Illinois’s total population lives in non-elderly married-couple families. These families have 60 percent of Illinois’s 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%
<i>Addendum:</i>			
Married, all	60%	61%	70%
Unmarried, all	40%	39%	30%

\*Includes dependents.

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

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

# ECONOMIC AND SOCIAL INDICATORS

State tax systems should be designed—and modified—with the state’s economic and social conditions in mind. The appropriate tax structure for Illinois, and for any state, depends on the structure of the state’s economy and the patterns of government services demanded by its citizenry. For this reason, it is important to assess the state of the Illinois economy, and how it has changed over the past several decades. It is equally important to assess various social indicators as a means of understanding the current quality of life in Illinois and how it has evolved over time. Such an analysis can provide useful insights into how tax and budget policies can promote greater social and economic well-being in the future. This chapter surveys the state of the Illinois economy—and assesses how its growth has affected various groups of Illinoisans. The chapter evaluates the quality of life in Illinois through analysis of the state’s economy and infrastructure, health indicators, educational achievement, environment, and crime. When possible, these indicators are compared to the national average, and to neighboring states. The chapter also places these economic and social indicators in historical context.

Our analysis reveals two broad patterns in the growth of the Illinois economy: relatively slow growth in the 1980s, followed by relatively rapid growth in the 1990s. The state’s economy grew during the 1980s—but at a slower rate than the nation as a whole. And different sectors of the economy fared quite differently: the state’s manufacturing sector declined dramatically, while the service, finance, insurance, and real estate sectors grew substantially. In 1979, most indicators of economic well-being suggested that Illinois ranked above most of the other 50 states. By the end of the 1980s, many indicators placed Illinois nearer the middle—and, sometimes, at the lower end—of the 50-state rankings.

Illinois fared much better in the 1990s. In keeping with the national trend, economic and social conditions improved significantly. But unfortunately, in most sectors the rebound in the 1990s was not sufficient to enable Illinois to regain all the ground it had lost relative to other states in the 1980s. Thus by 1999, although many measures

of economic and social attainment showed recent improvement, Illinois’s rankings were not as good as they were 20 years earlier. In addition, many of Illinois’s citizens did not share in the prosperity of the 1990s, creating inequalities that could prove costly during an economic downturn. The state continues to perform poorly on several basic indicators of social well-being such as infant mortality, child poverty and health insurance coverage. Finally, there are indications that the state’s recent healthy economic growth is slowing and perhaps even reversing itself.

## I. General Economic Indicators

Over the last 20 years Illinois has experienced two distinct patterns of economic growth. The 1980s was a period of relatively slow growth while the 1990s was one of strong economic growth. As a result, the state economy generally lost ground compared to the rest of the nation during the 1980s, and regained some of this ground during the 1990s. The most recent data suggest that the state’s economic growth may be slowing once again.

Between 1979 and 1989, Illinois’s total personal

### Real Per Capita Personal Income in 1999 Dollars

	1979	Rank	1989	Rank	1999	Rank
Illinois	\$23,505	7	\$26,379	14	\$31,145	8
Indiana	\$20,226	26	\$22,531	31	\$26,143	31
Iowa	\$20,914	22	\$22,252	33	\$25,615	34
Kentucky	\$17,532	41	\$19,618	43	\$23,237	42
Michigan	\$22,262	12	\$24,555	21	\$28,113	19
Missouri	\$19,994	29	\$22,952	27	\$26,376	30
Wisconsin	\$21,298	18	\$23,242	24	\$27,390	22
<b>United States</b>	<b>\$21,181</b>		<b>\$24,944</b>		<b>\$28,542</b>	
<b>IL as % of US</b>	<b>111%</b>		<b>106%</b>		<b>109%</b>	

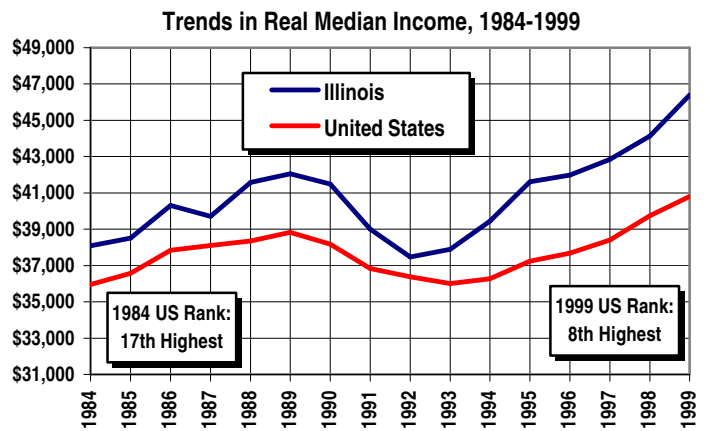
SOURCE: Bureau of Economic Analysis, US Dept of Commerce.

income grew at a rate that was less than half the national average, and slower than the rate in 40 other states. However, Illinois’s population hardly grew at all (0.1 percent) while the population of the country rose by nearly 10 percent during the decade. This

stagnation in Illinois's population was, to some extent, a reflection of the lack of opportunity in the state. But at the same time, the absence of population growth partially mitigated the effects of slow personal income growth. Thus, Illinois's **inflation-adjusted per capita personal income**, one of the most commonly used measures of the relative affluence of states, grew by 12.2 percent from 1979 to 1989, about 70 percent of the national average and slower than in 26 other states. Illinois's relatively slow growth was due in part to a regional slowdown, and relative to its neighbors Illinois did not fare badly. Indeed, Illinois's per capita income in the 1980s grew at a rate that was faster than that of all of its neighboring states, except Missouri.

During the 1990s, Illinois's personal income grew more than twice as fast as it did in the 1980s and almost as rapidly as the national average. The state's population grew by 6.3 percent, but this was only 60 percent of the nation's population growth rate. As a consequence, Illinois's per capita personal income grew faster than the national average and recovered some, but not all, of the ground it had lost in the 1980s relative to the national average. In 1979, Illinois's per capita personal income was 11 percent above the national average, ranking seventh in the nation. By 1989 it had fallen to just 6 percent above the national average, ranking 14<sup>th</sup>, but by 1999 it had risen to 9 percent above the national average, 8<sup>th</sup> highest nationally.

**Per capita Gross State Product (GSP)** is one of the best measures of the overall size of a state's economy. The changes in per capita GSP closely mirror those in per capita personal income. During the 1980s, Illinois's economy grew slowly relative to the national economy but, over the next decade per capita GSP in Illinois grew faster than the national average and much of the ground lost in the 1980s was recovered. In 1979, the state's per capita



GSP was 10 percent above the national average, ranking 8<sup>th</sup> among the 50 states. By 1989, its per capita GSP ranking fell to 13<sup>th</sup>, just 5 percent above the national average. By 1999, Illinois's per capita GSP recovered somewhat to 8 percent above the national average (\$36,746 versus \$34,138), ranking 11<sup>th</sup> nationally.

**Median household income** is another common measure of economic well-being. It reflects the income of the typical household—the household in the middle of the income distribution. Median household income data is only available after 1983. For the comparable years, the median income data is consistent with the GSP and personal income data. Illinois's median income grew faster in the 1990s than in the 1980s. In 1999 Illinois ranked 8<sup>th</sup> among the states with a median income almost 14 percent above the national average (\$46,392 versus \$40,816).

The aggregate data on personal income, Gross State Product and median income show that Illinoisans as a whole are better off than residents of many states. Yet these aggregate measures can be quite misleading as indicators of how different groups within an economy, such as the wealthy or the poor, are faring. For example, an increase in total per capita income can be the result of rapid income growth for a small number of wealthy citizens, combined with stagnant growth or an actual *decline* in the incomes of poor and middle-class taxpayers. There is evidence that this is exactly what occurred in Illinois. One analysis found that the average income of the wealthiest 5 percent of Illinois's population grew by more than 42 percent from the late 1970s to the late 1990s, while the average income of the poorest fifth of Illinois's

**Gross State Product per capita as % of U.S. average**

	1979		1989		1999	
	% of US	Rank	% of US	Rank	% of US	Rank
Illinois	110%	8	105%	13	108%	11
Indiana	94%	28	88%	32	90%	30
Iowa	101%	15	87%	35	87%	33
Kentucky	87%	37	81%	39	84%	40
Michigan	101%	17	92%	25	92%	27
Missouri	95%	27	92%	26	91%	28
Wisconsin	97%	23	90%	29	93%	26

SOURCE: Bureau of Economic Analysis.

population actually fell by 1 percent.<sup>1</sup> As a consequence, income is more unevenly distributed in Illinois than it is in 27 other states, including all of its neighboring states except Kentucky.

**Employment growth** is another key indicator of the relative health of an economy. The Illinois economy created only 1,500,000 new jobs between

Growth in Total Employment						
	1979-99	Rank	1979-89	Rank	1989-99	Rank
Illinois	26.0%	41	9.2%	43	15.4%	38
Indiana	34.4%	33	11.7%	37	20.3%	27
Iowa	23.9%	45	3.5%	48	19.7%	28
Kentucky	38.0%	28	12.6%	34	22.6%	20
Michigan	31.6%	37	12.0%	35	17.5%	34
Missouri	34.8%	31	14.8%	30	17.5%	33
Wisconsin	37.7%	29	12.0%	36	23.0%	19
<b>United States</b>	<b>44.6%</b>		<b>21.1%</b>		<b>19.3%</b>	
<b>IL as % of US</b>	<b>58.3%</b>		<b>43.4%</b>		<b>79.5%</b>	

Source: Bureau of Labor Statistics

1979 and 1999. That 26 growth rate that was substantially below the 45 percent U.S. average, and was slower than in 40 other states. While job growth in Illinois was faster in the nineties than in the eighties, in both decades job growth in Illinois lagged behind the national average and job growth in most other states. Over the twenty-year period, job growth in Illinois was slower than in all of its neighboring states except Iowa.

A distressing aspect of the sluggish job growth in Illinois is that it has been caused in part by the collapse of manufacturing employment. Between 1979 and 1999, Illinois lost a quarter of all its manufacturing employment—some 320,000 jobs. This compares unfavorably to a 10 percent drop in manufacturing jobs in the nation as a whole. Most of these jobs were lost in the 1980s, a decade in which manufacturing employment losses were worse in Illinois than in almost every other state. During the 1990s, Illinois continued to lose manufacturing jobs but at a slower rate—down almost 3 percent in the 1990s compared to the 23 percent drop in the 1980s. Manufacturing jobs are important for economic vitality because such jobs tend to be higher paying than most. When manufacturing workers spend their relatively high salaries, sales and earnings are increased throughout the economy. Replacing manufacturing

jobs with lower-paying employment, on the other hand, stifles consumer demand in the state, hurting businesses that rely on local consumer spending.

Not surprisingly, the dramatic collapse in manufacturing jobs in Illinois has translated into lower pay for manufacturing workers both absolutely and relative to manufacturing workers in the rest of the country. Between 1979 and 2000, inflation adjusted manufacturing wages fell 17 percent in Illinois as compared to a 10 percent reduction nationwide. In 1979, Illinois's manufacturing wages were 9 percent above the national average and ranked 9<sup>th</sup> among the states. In 2000, Illinois's manufacturing wages were equal to the national average, ranking 22<sup>nd</sup> among the 50 states. To put these figures in more tangible terms consider that the average full-time manufacturing worker in Illinois earned about \$36,000 in 1979 and less than \$30,000 in 2000.

In 1979, the unemployment rate in Illinois was 5.5 percent, below the national average of 5.8 percent. However, due in part to sluggish employment growth and the collapse in manufacturing jobs, the Illinois unemployment worsened significantly as the 1980s began. The state's unemploy-

Average Hourly Wages in Manufacturing						
	1979		1989		2000	
	Wage	Rank	Wage	Rank	Wage	Rank
Illinois	\$17.31	9	\$15.57	7	\$14.39	22
Indiana	n/a	n/a	\$16.25	6	\$15.83	5
Iowa	\$18.38	7	\$15.03	17	\$14.66	17
Kentucky	\$16.06	20	\$14.40	27	\$14.82	15
Michigan	\$20.71	2	\$18.76	1	\$19.20	1
Missouri	\$15.89	23	\$14.57	24	\$14.40	21
Wisconsin	\$17.24	10	\$14.96	19	\$14.85	14
<b>United States</b>	<b>\$15.89</b>		<b>\$14.55</b>		<b>\$14.38</b>	
<b>IL as % of US</b>	<b>109%</b>		<b>107%</b>		<b>100%</b>	

Source: Bureau of Labor Statistics

ment rate was above the national average in every year from 1980 to 1993, ranging from a low of 6 percent in 1989 to 11.4 percent in 1983. Between 1994 and 1999, however, the state employment picture brightened. More than 100,000 new jobs a year were created, and the unemployment rate fell from 5.7 percent in 1994 to 4.3 percent in 1999. In each year during this period, Illinois's unemployment rate was either roughly equal to or

<sup>1</sup> *Pulling Apart: A State-by-State Analysis of Income Trends*. P.8, Table 1, January 2000, Economic Policy Institute and Center on Budget and Policy Priorities.



### Unemployment As a % of the Civilian Labor Force

	1979	Rank	2000	Rank
<b>Illinois</b>	<b>5.5%</b>	<b>24</b>	<b>4.4%</b>	<b>37</b>
Iowa	4.1%	8	2.6%	4
Indiana	6.4%	36	3.2%	12
Kentucky	5.5%	24	4.1%	30
Michigan	7.8%	49	3.6%	18
Missouri	4.5%	12	3.5%	15
Wisconsin	4.5%	12	3.5%	15
<b>United States</b>	<b>5.8%</b>		<b>4.0%</b>	
<b>IL as % of US</b>	<b>94.8%</b>		<b>110.0%</b>	

Source: U.S. Bureau of Labor Statistics.

lower than the national rate.

In the past two years, the trend in the state's unemployment rate has reversed itself once again. Illinois unemployment surpassed the national average in April of 1999, and has steadily increased since then. In June of 2001, the state unemployment rate was 5.2 percent, worse than all but six other states. The recent rise in unemployment is partially due to the large number of mass layoffs in the state: over the past two years the rate of mass layoffs per 1000 businesses has been higher in Illinois than in almost every other state.

The changing employment patterns over the past two decades appear to have had an impact on poverty rates in Illinois, as well. As the 1980s began, the state's poverty rate was generally below the national average. But as high-paying manufacturing jobs fled the state in the mid-1980s, the poverty rate in Illinois equaled—or exceeded—the

### Percent of Persons Below Poverty Level

	1980	Rank	1990	Rank	2000	Rank
<b>Illinois</b>	<b>12.3</b>	<b>24</b>	<b>13.7</b>	<b>29</b>	<b>11.6</b>	<b>34</b>
Indiana	11.8	22	13.0	24	8.4	13
Iowa	10.8	18	10.4	14	7.1	4
Kentucky	19.3	44	17.3	44	11.8	35
Michigan	12.9	28	14.3	34	10.1	25
Missouri	13.0	30	13.4	28	7.8	7
Wisconsin	8.5	5	9.3	9	9.2	18
<b>United States</b>	<b>13.0</b>		<b>13.5</b>		<b>11.3</b>	
<b>IL as % of US</b>	<b>95%</b>		<b>101%</b>		<b>103%</b>	

Source: U.S. Bureau of the Census

national poverty rate. By 1985, the state's poverty rate was 11 percent above the national average. After 1992, as job creation in other sectors began to compensate for the lost manufacturing jobs, and as the state's manufacturing job loss itself slowed, Illinois was able to reduce its poverty rate and, until recently, keep it significantly below the national rate. In 1998, the state's poverty rate was just 80 percent of the national average. But Illinois has lost its advantage over the nation in the past two years. In 2000, the state's poverty rate was 11.6 percent, 3 percent *above* the national average. More than 1.4 million Illinois residents lived in poverty in 2000. Among Illinois's neighbors, only Kentucky had a larger percentage of its people living in poverty in 2000. Especially worrisome is that the percentage of children who live in poverty in Illinois remains stubbornly high at 15 percent (in 1999): this represents some 500,000 Illinois children.

### Average Earnings as percent of United States average

	1981	Rank	1989	Rank	1999	Rank
<b>Illinois</b>	<b>108%</b>	<b>6</b>	<b>107%</b>	<b>8</b>	<b>109%</b>	<b>6</b>
Indiana	100%	16	93%	23	90%	24
Iowa	91%	33	82%	43	81%	38
Kentucky	93%	28	84%	40	83%	34
Michigan	116%	2	110%	7	107%	8
Missouri	95%	26	93%	24	90%	25
Wisconsin	94%	27	90%	27	89%	27

Source: Bureau of Labor Statistics

The picture with regard to earnings in Illinois is mixed. The good news is that between 1981 and 1999 the increase in average annual earnings was greater in Illinois than it was in the nation as a whole (16.8 percent versus 15.9 percent). Only 16 states did better than Illinois and every state in the region fared far worse. While Illinois increased its average annual earnings from 108 percent of the national average in 1981 to 109 percent in 1999, all of its neighbors saw their earnings decline relative to the national average.

The bad news has several aspects. First, nearly three quarters of the annual average earnings growth in Illinois took place in the second half of the 1990s, as the unemployment rate dropped sharply. This suggests that short-term labor market conditions (i.e. low unemployment), rather than fundamental long-term structural changes, may

have been the source of the improvement. If this is the case, then a downturn that raises the unemployment rate, such as may have begun in 2000, could quickly dissipate the earnings gains.

**Share of jobs paying below the poverty line (\$8.19/hr) for full time work.**

	1979	1989	1999
<b>Illinois</b>	<b>17.6</b>	<b>25.5</b>	<b>23.9</b>
Indiana	24.2	34.8	24.3
Iowa	25.7	35.4	25.1
Kentucky	26.8	36.5	31.4
Michigan	17.9	27.2	22.9
Missouri	26.2	33	24.7
Wisconsin	21.6	30.3	22.7
<b>United States</b>	<b>23.7</b>	<b>28.5</b>	<b>26.8</b>

Source: Economic Policy Institute

Second, changes in average annual pay have not reflected well what is happening to the earnings of different groups of workers in the Illinois economy. It has already been pointed out that manufacturing wages plummeted in Illinois. In addition, in 1979 Illinois stood out among its neighbors and in the US as having few poverty wage jobs. But, between 1979 and 1999 the share of jobs in Illinois that paid less than the federal poverty line increased 6.3 percentage points (from 17.6 percent to 23.9 percent) while the national rate increased only 3.1 percentage points (from 23.7 percent to 26.8 percent). And while average annual pay performed well recently, median hourly wages had yet to reach 1979 levels by 1999. In 1979 the median worker in Illinois made \$13.33 per hour, while in 1999 the median worker made merely \$12.43. Wages for workers in the bottom fifth of the income scale tell a similar story, falling from \$8.44 to \$7.35 per hour between 1979 and 1999.

The increase in average annual pay, along with the increase in the number of jobs paying below poverty wages and the decrease in both median wages and the wages of the lowest earners, implies that the growth in earnings has been unevenly distributed. Indeed, income gains have accrued largely to those at the top of the income scale as increases in demand for highly skilled, highly paid employees rose sharply relative to the supply of such workers. As firms competed for these workers, they were forced to pay higher wages. Meanwhile, those workers in the bottom half of the income scale were forced to work longer hours to maintain

income levels. Obviously, however, workers whose hourly wages are falling cannot endlessly compensate by increasing their working hours. At a certain point, if hourly wages do not rise, then their incomes stagnate or fall.

Over the past two decades, Illinois has experienced relatively slow employment growth and even slower population growth. This combination has helped reduce the unemployment rate, particularly in the latter half of the 1990s, but not as much as might have been anticipated—and not enough to raise wages at the middle and lower end of the income scale. The potential tightening of the labor market in Illinois has been mitigated to some extent by a swift increase in the proportion of adults participating in the workforce. Between 1979 and 1999, the labor force participation rate in Illinois rose dramatically from 64.6 percent to almost 70 percent. Only 11 states, including Iowa and Missouri, enjoyed a greater increase in labor force participation rates over this period. In 1979, Illinois's labor force participation rate already exceeded the national average and Illinois ranked 28<sup>th</sup> among the 50 states. By 1999 Illinois's lead over the national average had grown and its ranking rose to 17<sup>th</sup>.

**Labor Force Participation Rates, 1979-1999**

	1979	Rank	1989	Rank	1999	Rank
<b>Illinois</b>	<b>64.6%</b>	<b>28</b>	<b>68.1%</b>	<b>26</b>	<b>69.7%</b>	<b>17</b>
Indiana	66.1%	18	68.3%	23	68.3%	25
Iowa	66.5%	14	70.2%	10	71.9%	11
Kentucky	61.3%	38	62.3%	47	64.3%	43
Michigan	64.2%	31	65.7%	37	68.5%	24
Missouri	63.1%	36	66.8%	32	68.7%	22
Wisconsin	68.2%	7	71.2%	6	72.3%	6
<b>United States</b>	<b>63.7%</b>		<b>66.5%</b>		<b>67.1%</b>	

Source: Bureau of Labor Statistics

If the growth in the labor force participation rate in Illinois over the last two decades had been slower, then it is possible that the unemployment rate would have been lower and wages would have been higher. But higher wages, unaccompanied by increases in labor productivity or reductions in the other costs of doing business in Illinois, might have encouraged some firms to move out of state in search of cheaper labor. Thus, the reduction in the unemployment rate and the increase in wages may have been undermined by slower job growth.

The scenario outlined above illustrates a dilemma that the state of Illinois may face in the future. In order for the citizens of the state to achieve the

highest possible levels of economic well-being, unemployment will need to be low and wages will need to be high. High wages, however, may make it difficult for the state to retain, let alone attract, businesses and jobs.

### Employment Growth for Non-Farm Sectors

	Avg annual pay in 1998	1979-99	1979-89	1989-99
Services	\$ 31,609	94%	43%	36%
Construction	\$ 41,806	43%	16%	22%
Fin., insur., real estate	\$ 53,217	40%	18%	19%
Transportation	\$ 41,510	29%	9%	19%
Retail	\$ 17,391	27%	14%	10%
Government	\$ 34,483	9%	2%	7%
Wholesale	\$ 45,696	7%	11%	-4%
Manufacturing	\$ 42,425	-25%	-23%	-3%

Source: Bureau of Labor Statistics

This potential tension between low unemployment and high wages and job growth is not inevitable. If Illinois is proactive in making investments in its labor force, infrastructure and other assets, then the effect of rising wages pushing firms out of state can be countered. Increasing the productivity of the labor force and the efficiency of the economy will both *encourage* employers to expand employment opportunities and *enable* employers to pay higher wages. Firms are willing to pay high wages in a particular location as long as that location provides sufficient productivity and efficiency gains to justify the high wages. A high wage economy, in turn, promotes a “virtuous cycle” as workers spend their additional earnings in the state and stimulate demand, sales, and, ultimately, profits.

Illinois does not seem to be on a high-wage trajectory. The manufacturing jobs that were lost in the 1980s have largely been replaced by jobs in the service sector. Across the state, employment in services expanded by an impressive 36 percent between 1989 and 1999, compared to an overall job growth rate of 15.4 percent. While the service sector is broadly defined, and includes many high-paying occupations, service employment is, on average, one of the lowest-paying sectors in the Illinois economy: in 1998, Illinois service employees made, on average, less than workers in every other sector of the economy except the retail sector.

Illinois has also enjoyed substan-

tial employment growth in some high-wage sectors of the economy. During the past decade, employment in construction, transportation, and financial services each grew by about 20 percent, but none of them came close to matching the size and growth rate of the service sector.

## II. Infrastructure

The physical infrastructure of an economy is fundamental to its health and growth potential. The infrastructure’s role in the economy is similar to the role of the skeletal, nervous, and cardiovascular systems in the human body: each needs to be in good condition in order for the body to function well. Likewise, the various components of the physical infrastructure (roads, bridges, sewage systems, telecommunication networks, etc.) need to be adequately developed and well maintained in order for an economy to grow rapidly and efficiently.

Infrastructure is key to attracting and retaining business. In particular, the adequacy and quality of roads, bridges, and sewage systems are among the primary factors that businesses consider when making investment location decisions. Infrastructure is especially important in developing a high-wage economy, since high quality infrastructure can help a firm to be profitable even when faced with a relatively high cost for labor.

Illinois’s performance in terms of infrastructure is mixed. Only 15.1 percent of Illinois’s highways were considered in poor condition in 1999, better than in 34 other states, and below the national average of 20.1 percent. This represents a slight improvement over 1992, when 16.8 percent of Illinois’s highways were rated as deficient, better than only 31 other states. Illinois’s bridges paint a more complex picture. Although only seven states,

	Highway Miles at or below 2.5 PSR, 1999		Area of Bridges Deemed Deficient,		Sewage needs, next 20 yrs, 1996	
	% deficient	rank	% deficient	rank	\$m/capita	rank
Illinois	15.1%	16	27.6%	31	940.87	48
Indiana	30.8%	39	20.3%	8	903.83	46
Iowa	0.4%	3	24.6%	26	437.06	24
Kentucky	18.8%	25	24.9%	28	644.42	36
Michigan	28.4%	37	40.1%	46	528.37	29
Missouri	4.6%	6	31.1%	37	595.84	33
Wisconsin	26.8%	34	20.1%	7	441.60	25
<b>United States</b>	<b>20.1%</b>		<b>28.0%</b>			

Source: Dept. of Transportation, EPA



and none of its neighbors, have a smaller proportion of deficient bridges, when the square-footage of the bridges in question is taken into account, Illinois does worse than 30 states, including all but two of its neighbors: Michigan and Missouri. Finally, Illinois's sewage system is in dire need of investment. By one measure, in 1996 only two states had a greater unmet need for sewage treatment systems than Illinois. This can be a serious threat to future growth because many businesses will not be able to locate in areas with inadequate sewage facilities.

Although these measures indicate the condition of the existing infrastructure, they do not indicate whether this infrastructure is sufficiently comprehensive. Unfortunately, no good statistics are available to provide that information. However, data on the congestion of transportation systems in the greater Chicago area suggest that the transportation infrastructure is not meeting the needs of businesses and commuters in the Chicago metropolitan area.

### III. Education

Education is arguably the single most important factor determining long-term economic growth. The productivity and growth of an economy are directly related to the level of education and training of its workforce. In order for a state to maintain its economic competitiveness it must develop a workforce that has the basic skills needed by employers. The workforce, furthermore, must be able to adapt rapidly to ever changing economic circumstances. Education and training are the best ways to provide these skills. In light of the employment data discussed earlier, it is important for Illinois to improve the skills of a broad section of its labor force if it hopes to maintain a high-pay, high-skill economy in the future.

Perhaps the broadest indicators of the skill levels of the workforce are measures of educational attainment. In today's economy, most jobs require at least a high school or college degree. Illinois's record in providing its citizens with these requirements is, once again, mixed.

Slightly more residents of Illinois, 25 years of age or older, have high school diplomas than do residents of the nation as a whole (85.5 percent versus 84 percent). Unfortunately however, the ratio in Illinois is higher than the ratio in only 21 other states including only two of its neighboring

#### High school graduates as % of 9th grade enrollment

	1989	Rank	1999	Rank
<b>Illinois</b>	<b>75.6</b>	<b>21</b>	<b>76.5</b>	<b>14</b>
Indiana	76.3	19	70.4	27
Iowa	85.8	5	84.7	3
Kentucky	69.0	39	67.8	32
Michigan	73.6	29	68.9	30
Missouri	74.0	28	70.6	26
Wisconsin	84.9	7	79.5	8

Source: Brizius and Foster and State Policy Research, Inc.

states. This makes the Illinois workforce unattractive compared to neighboring states. The percentage of those holding high school diplomas has increased substantially since 1979, but the increase in Illinois has been virtually indistinguishable from the rise nationwide.

Illinois has shown marked improvement compared to other states in bachelor's degree attainment. In 1989, 21.1 percent of people over age 25 in Illinois had a four-year college degree: better than in 28 states, including all of Illinois's neighbors except Missouri, but equal to the national average. By 2000, Illinois had reached 27.1 percent of its residents with a bachelor's degree, higher than the national average and ahead of 34 other states.

Educational attainment, however, includes people well past the conventional age of most students, and therefore depends heavily on decisions made in the past, often the distant past. A better measure of current commitment to educational attainment and for projecting the quality of the workforce in the future is high school graduations as a percent of 9<sup>th</sup> grade enrollments four years earlier. By this measure, Illinois improved only slightly, from 75.6 percent in 1989 to 76.5 percent in 1999. But largely due to poor performance by other states, Illinois climbed from 21<sup>st</sup> among the states in graduation rate to 14<sup>th</sup>.

#### Average Teacher Salary, 1999 dollars

	1979	Rank	1989	Rank	1999	Rank
<b>Illinois</b>	<b>\$37,927</b>	<b>10</b>	<b>\$41,870</b>	<b>12</b>	<b>\$45,569</b>	<b>8</b>
Indiana	\$32,801	22	\$39,203	20	\$41,163	14
Iowa	\$32,574	24	\$34,655	32	\$34,927	34
Kentucky	\$30,241	32	\$33,515	37	\$35,526	31
Michigan	\$41,341	4	\$46,609	5	\$48,207	5
Missouri	\$29,187	39	\$34,961	31	\$34,746	36
Wisconsin	\$34,227	19	\$41,378	13	\$40,657	15
<b>United States</b>	<b>\$34,517</b>		<b>\$39,744</b>		<b>\$40,582</b>	

Source: National Education Association

The fact that more students in Illinois are finishing high school and that the workforce as a whole is getting more educated, especially with regard to post-secondary education, is clearly a positive development. Of course, this tells one little about the quality of the education that the students are receiving. Assessing quality is extremely difficult, especially as Illinois declined to participate in the National Assessment of Educational Progress. Nevertheless, there are other measures by which to evaluate Illinois commitment to quality education.

A basic measure of commitment to quality in education is expenditures per pupil. Although there is considerable controversy over the importance of funding compared to other factors, there can be no doubt that the amount of resources available plays an important role. By this measure, Illinois has done poorly relative to the nation. Expenditures per pupil fell from 113 percent of the national average in 1979 to 95 percent in 1999. Illinois's rank among the states fell from 12<sup>th</sup> in 1979 to 24<sup>th</sup> in 1989, and fell again to 28<sup>th</sup> in 1999.

**Spending per Pupil as % of United States Average**

	<b>1979</b>	<b>rank</b>	<b>1989</b>	<b>rank</b>	<b>1999</b>	<b>rank</b>
<b>Illinois</b>	<b>113%</b>	<b>12</b>	<b>95%</b>	<b>24</b>	<b>95%</b>	<b>28</b>
Indiana	87%	33	94%	25	107%	18
Iowa	109%	16	97%	22	91%	34
Kentucky	80%	41	77%	40	99%	23
Michigan	116%	9	112%	13	121%	7
Missouri	83%	36	85%	33	83%	38
Wisconsin	111%	13	114%	12	114%	11

Source: U.S. Department of Education, NCES

Numerous studies have shown that students benefit from small class size and individual attention from school staff and teachers. Over the past decade, Illinois has improved both its pupil-staff ratio and its pupil-teacher ratio. In terms of the pupil-staff ratio, Illinois moved from slightly behind the national average to parity with the national rate and its state ranking rose from 38<sup>th</sup> to 32<sup>nd</sup>. Despite the improvement in its pupil-teacher ratio, Illinois has fallen behind the national average pupil-teacher ratio and dropped in the state rankings from 26<sup>th</sup> to 34<sup>th</sup>. Thus, despite improvements, these statistics show that there is still much to do to make Illinois competitive. In both measures Illinois is in the bottom half of states, and in the latter it is falling behind. If Illinois wishes to move into a high-wage

economy, it cannot rest below the middle and be content with modest improvements.

	<b>Students per Teacher</b>		<b>Students per Staff</b>	
	<b>1999</b>	<b>rank</b>	<b>1999</b>	<b>rank</b>
<b>Illinois</b>	<b>16.20</b>	<b>34</b>	<b>8.30</b>	<b>32</b>
Indiana	16.80	39	7.89	26
Iowa	14.90	17	7.54	16
Kentucky	15.40	28	6.94	5
Michigan	18.00	44	8.19	31
Missouri	14.30	15	7.74	20
Wisconsin	14.40	13	7.98	27
<b>United States</b>	<b>16.10</b>		<b>8.34</b>	

Source: U.S. Department of Education, NCES

Teachers' salaries are another indicator of a state's commitment to education. They reflect the state's willingness to pay competitive wages to recruit talented professionals to teach its children. By this measure, Illinois has done well. Salaries increased 20 percent in real terms between 1979 and 1999, compared to 18 percent in the nation. Teacher pay in Illinois ranked 8<sup>th</sup> in the nation in 1999, ahead of all of its neighbors except Michigan, and equaled 112.3 percent of the national average.

As pointed out earlier, Illinois has a moderately high, and, more importantly, increasing rate of college level educational attainment, but it has yet to turn that into a high-skilled work force. For example, in 1999 Illinois exceeded its neighbors in employed doctoral scientists and engineers per 1,000 workers, at 1.83, but this is below the national average of 2.03 and ranks only 22<sup>nd</sup> among the states. Also, although Illinois increased its university research and development budget from \$51.85 per capita to \$90.79 between 1989 and 1999, it failed to keep up with the rest of the country and dropped from 27<sup>th</sup> place to 31<sup>st</sup>.

Nevertheless, Illinois has a large potential supply of highly trained workers because its institutions of higher learning train a great number of scientists and engineers. Between 1989 and 1999, Illinois expanded its population of science and engineering graduate students per million population from 1,664 to 1,862, a 12 percent increase. In 1999 only five states had a higher proportion of these students. During this same period, the United States as a whole reduced its proportion from 1,551 to 1,508 per million. All of Illinois's neighbors experienced declines except Kentucky, which after an 11 percent increase, still

	Number of Employed Doctoral Scientists and Engineers per 1,000		University R&D Expenditures per Capita	
	1999	rank	1999	rank
<b>Illinois</b>	<b>1.83</b>	<b>22</b>	<b>\$ 90.79</b>	<b>31</b>
Indiana	1.49	36	\$ 77.47	35
Iowa	1.54	33	\$130.79	6
Kentucky	0.98	48	\$ 69.15	39
Michigan	1.68	29	\$ 93.21	28
Missouri	1.72	28	\$100.56	22
Wisconsin	1.58	31	\$106.78	18
<b>United States</b>	<b>2.03</b>			

Source: National Science Foundation

had only 954 science and engineering graduate students per one million population. Illinois needs to create job opportunities so that these students will stay and work in the state after they complete their studies.

These job opportunities are not likely to develop, however, without a renewed commitment to education for the broad base of the population. High technology relies not only on the scientists and engineers at the top, but on a large, educated network of support workers, from administrators to accountants. Where the broad population is not well educated, high tech firms will be reluctant to locate, fearing a shortage of adequately skilled workers. An important step, therefore, toward building a successful, high-wage economy is to provide excellent primary and secondary education.

Illinois does well on some measures and poorly on others when it comes to education. Such a mixed record in education will make it difficult for Illinois to preserve the recent gains it has made in wages and employment, especially in the face of an economic slowdown. Stable increases in pay must be based on greater productivity, not simply a tighter state labor market, and the best way to improve workforce productivity is to improve education.

#### IV. Health

Health is fundamental to well-being. To the extent that states want to improve the quality of life of their citizens, therefore, they need to deal with health related issues. Because health conditions affect the quality of life, they influence decisions about where to live and where to start a business. Health conditions and availability also affect the quality and productivity of labor. Hence,

health is one of the keys to economic growth and development.

Health is especially important for the future of Illinois given that health impacts the quality of labor. For as noted earlier, it is essential for Illinois to improve the productivity of its labor force in order to permit the transition from a medium skill, medium wage economy to a high wage, high skill economy, and thereby preserve the gains of recent years.

Statistics on health and health care cover a wide variety of issues. We have selected indicators that reflect the average health of states' populations and the availability of care at the state level. Unfortunately, data for life expectancy, one of the best indicators of a population's health, are not available at the state level.

Health statistics for Illinois are not very impressive. Even in areas where Illinois has posted significant gains, Illinois does not rank high compared to other states, and there are some areas where Illinois compares very unfavorably. Nevertheless, there have been some encouraging improvements that could be studied in order to broaden and deepen the successes.

Two of the broadest measures of the health conditions of a state's population are the death rates from heart disease and cancer, the two leading causes of death. The death rates in Illinois due to heart disease and cancer are both higher than the national average, yet there have been some improvements. In 1978, 379.6 people were dying of heart disease for every 100,000 residents

	Deaths by Cause, per 100,000 Population					
	Heart Disease			Cancer		
	1978	1997	rank	1978	1997	rank
<b>Illinois</b>	<b>379.6</b>	<b>274.3</b>	<b>27</b>	<b>186.8</b>	<b>205.8</b>	<b>24</b>
Indiana	334.2	284.1	30	179.3	210.3	31
Iowa	380.5	319.4	41	187.5	222	40
Kentucky	379.1	318.8	40	183.4	229.5	44
Michigan	321	278.8	28	166.5	200.6	18
Missouri	380.2	341.7	47	200.5	221.4	38
Wisconsin	349	264.9	23	177	204.6	23
<b>United States</b>	<b>334.3</b>	<b>271.6</b>		<b>181.9</b>	<b>201.6</b>	

Source: National Center for Health Statistics

of Illinois, compared to 334.3 in the nation as a whole. Between then and 1997, Illinois posted the third best improvement of any state in the country, reducing its heart disease death rate by 28 percent

to 274.3 compared to a national rate of 271.6, and moving from 43<sup>rd</sup> to 27<sup>th</sup> among the states: better than any of its neighbors except Wisconsin. Cancer rates, on the other hand, have worsened, but not as fast as in the nation as a whole. In 1978, the death rate from cancer in Illinois was 186.8 per 100,000 residents, compared to 181.9 in the nation as a whole. By 1997, Illinois had a rate of 205.8, while the national average had risen to 201.6. Therefore, despite Illinois's increase in cancer deaths, it moved from 33<sup>rd</sup> to 24<sup>th</sup> among the states, posting a smaller increase than all of its neighbors.

Infant Deaths per 100,000 Live Births				
	1989	Rank	1999	Rank
<b>Illinois</b>	<b>10.9</b>	<b>45</b>	<b>8.3</b>	<b>41</b>
Indiana	9.4	34	4.7	2
Iowa	8.2	16	7.2	29
Kentucky	8.7	23	7.2	29
Michigan	10.5	43	8.5	42
Missouri	9.7	38	7.6	35
Wisconsin	8.4	17	6.9	25
<b>United States</b>	<b>9</b>		<b>7.2</b>	

Source: National Center for Health Statistics

These statistics should be interpreted with some caution because they are not age adjusted, and it is well known that older populations suffer from heart disease and cancer at rates that are higher than younger populations. However, the percent of Illinois's population that is over 65 is slightly lower than the nation as a whole, 12.3 percent to 12.7 percent in 1998, so these statistics may actually understate the relative death rates from these diseases in Illinois.

Infant mortality rates are another good indicator of health conditions. These rates are strongly negatively correlated with the health of mothers, especially their nutrition. They are also negatively correlated with the availability of prenatal and postnatal infant care. Illinois has done rather poorly by this measure. Although Illinois reduced its infant mortality rate substantially (from 10.9 to 8.3 deaths per 100,000 live births between 1989 and 1999 as the national average fell from 9.0 to 7.2) and its ranking climbed (from 45<sup>th</sup> to 41<sup>st</sup> place among the states), Illinois still sits near the bottom of the state rankings, with only Michigan among its neighbors doing worse.

Percent of Births with Low Birth Weight						
	1980	rank	1989	rank	1996-98	rank
<b>Illinois</b>	<b>7.2</b>	<b>33</b>	<b>7.7</b>	<b>38</b>	<b>8.0</b>	<b>36</b>
Indiana	6.3	19	6.6	22	7.8	31
Iowa	5.0	3	5.4	8	6.4	12
Kentucky	6.8	27	6.9	24	7.9	35
Michigan	6.9	30	7.6	37	7.7	30
Missouri	6.6	23	6.9	24	7.7	29
Wisconsin	5.4	9	5.8	15	6.4	13
<b>United States</b>	<b>6.8</b>		<b>7.0</b>		<b>7.5</b>	

Source: National Center for Health Statistics

A good indicator of not just current but also future health conditions is the percent of births with low birth weight. Low birth weight is associated with the poor health of mothers and the lack of prenatal care. Low birth weight is also a good predictor of future health problems for babies. Here too, Illinois has fared poorly, and has in fact lost ground relative to the other states. While the rate nationally rose from 6.8 percent to 7.5 percent between 1980 and 1998, the rate in Illinois rose from 7.2 percent to 8.0 percent, pushing it down from the 18<sup>th</sup> worst rate in the nation to the 15<sup>th</sup> worst, and worse than every other state in the region.

An important determinant of health conditions is the availability of health care. Here too Illinois has a mixed record. Although Illinois has kept pace with the United States average on physician density, and perhaps even improved on the geographic

Physicians per 100,000 population						
	1981	rank	1990	rank	2000	rank
<b>Illinois</b>	<b>186</b>	<b>13</b>	<b>217</b>	<b>12</b>	<b>263</b>	<b>10</b>
Indiana	129	41	158	41	201	38
Iowa	126	44	154	42	199	42
Kentucky	136	38	170	37	212	37
Michigan	161	24	184	27	258	12
Missouri	165	20	198	20	252	16
Wisconsin	160	25	188	25	230	25
<b>United States</b>	<b>185</b>		<b>216</b>		<b>261</b>	

Source: Medical Marketing Service, Inc.

dispersal of its physicians, the number of people who are without health insurance is growing at a rapid rate.



**Percent of Population Living in  
Primary Care Shortage Areas**

	<b>1989</b>	<b>Rank</b>	<b>2000</b>	<b>Rank</b>
<b>Illinois</b>	<b>7.6</b>	<b>39</b>	<b>7.1</b>	<b>11</b>
Indiana	3.6	20	9.8	26
Iowa	3.5	18	9.3	22
Kentucky	5.2	29	13.2	36
Michigan	4.5	25	11.9	33
Missouri	5.8	31	16.7	43
Wisconsin	4.2	22	9.8	25

Source: U.S. Dept. of Health & Human Services

One way to measure the availability of health care is to calculate the number of physicians per 100,000 of population. Illinois does well on this measure. Although Illinois is only slightly ahead of the national average (263 in Illinois versus 261 in the US as a whole) there are only 10 states that exceed the national average. Furthermore, between 1981 and 2000, Illinois kept pace with the US increase in physician density of 41 percent. None of Illinois's neighbors exceed the national average for physician density.

**Percentage of Non-Elderly Population  
without Health Insurance**

	<b>1989</b>	<b>Rank</b>	<b>1999</b>	<b>Rank</b>
<b>Illinois</b>	<b>11.2</b>	<b>17</b>	<b>15.7</b>	<b>25</b>
Indiana	14	27	12.3	12
Iowa	8.4	2	9.5	3
Kentucky	15	29	16.3	28
Michigan	9.2	3	12.4	13
Missouri	13.3	24	9.6	4
Wisconsin	10.2	12	12.2	9
<b>United States</b>	<b>15.3</b>		<b>17.4</b>	

Source: Census Bureau

A second measure suggests improvement in health care coverage in Illinois. Between 1989 and 2000, the percent of the population without primary care within easy economic and geographic reach declined from 7.6 percent to 7.1 percent while this indicator got worse in all of its neighboring states. Illinois climbed from 39<sup>th</sup> place to 11<sup>th</sup> place, from behind all of its neighbors to first among them. This statistic should be used with caution, however, because a place is reviewed for

designation as a health care shortage area only after an application is made on its behalf by a state or local government. Thus the "decline" in health care shortage areas in Illinois may reflect bureaucratic inaction rather than a real reduction in areas without primary care.

Health insurance coverage is another good measure of the availability of health services. Illinois is losing ground rapidly by this measure, although as of 1999 it still fared better than the national average. Between 1989 and 1999, the percentage of non-elderly residents not covered by health insurance rose from 15.3 percent to 17.4 percent nationwide and from 11.2 percent to 15.7 percent in Illinois. Thus, the rate in Illinois grew more than twice as fast as in the nation as a whole. Illinois tumbled from 17<sup>th</sup> to 25<sup>th</sup> among the states in health insurance coverage, worse than any neighboring state except Kentucky. Although health insurance coverage in Illinois is still better than the national average, if the trend of the past decade continues it threatens to lower the productivity of a large segment of Illinois's workforce as well as burden the health care system by draining expensive emergency room resources.

## V. Summary

Improvements in a state's economic well-being are a function of *extensive* and *intensive* development. *Extensive* development refers to growth that results from increases in the various factors of production. In simple terms, this means that output generally expands in response to increases in employment, factories, machinery, tools, equipment and infrastructure. *Intensive* development refers to growth that results from improvements in the quality of the existing factors of production. For example, improvements in the health, education and training of workers, infrastructure enhancements, and technological innovations, could be considered intensive development.

Some aspects of extensive development are by their very nature limited. For example, increases in employment are limited because as employment grows the pool of potential workers is gradually exhausted: at any given moment there are only so many people available to work. Once full employment is achieved, output expansion due to employment growth generally proceeds only if population grows. On the other hand, there are no known limits to intensive development. The health,

education, and training of workers can always be improved. Technological advances and infrastructure enhancements have no apparent bounds.

While state and local governments in the United States play a role in promoting extensive development (through, for example, investment in roads, bridges and other forms of infrastructure) they are generally more able to influence the pace of intensive development, through investments in the health, education, and physical and social environment of their people. These investments can be important stabilizers in a market economy. Market fluctuations can put great strain on business investment decisions and, thus, the availability of jobs. Government investments in education, efficient infrastructure, and quality health care provision, on the other hand, need not be decimated by economic downturns as long as the state and its citizens maintain their commitment to them. Making these investments when times are good and maintaining them when times are bad is one of the best ways to ensure that a slowdown will be brief and mild.

Finally, these investments make for a more productive workforce, allowing wages and quality of life to rise. When workers spend these wages in the state, they promote the growth of numerous sectors of the economy and particularly aid businesses and others that rely on local consumer spending. This virtuous cycle—rising worker productivity encourages firms to expand production, hire more workers and pay higher wages, which, in turn generates greater consumer demand and businesses sales and rising standards of living—is key to the development of a high-skill, high-wage economy in Illinois.

Along with the rest of the nation, Illinois has seen a period of great economic growth over the past decade. That period presented an opportunity for the state to invest in its economy in ways that would improve the quality of life and the long-term health of its economy. Indeed, Illinois has had advances in both intensive and extensive development. The high labor force participation rate in Illinois has been an important extensive factor driving the state's economy, just as Illinois's well-maintained roads and high rate of adults with college degrees have been an important intensive factor. However, with unemployment rising, an economic slowdown in progress, and a recession possible, it is unclear that Illinois has done enough.

Despite the great economic growth of the 1990s, Illinois has fallen behind many other states in education funding. In addition, an increasing number of state residents are without adequate health care. Infant mortality is high and low birth weight babies are numerous, suggesting that prenatal and postnatal care is inadequate. Poverty—particularly child poverty—remains high, negatively affecting the quality of life of hundreds of thousands of citizens and portending ill for the quality of the workforce in the future. Finally, the income gains of the past decade have not been enough, or distributed evenly enough, to reverse many of the wage losses of the 1980s, leaving many of the state's workers worse off than they were twenty years ago. Without appropriate investments in health, education, infrastructure, and the environment, an economic downturn could force firms to leave the state for areas with more productive workers or to cut wages or reduce payrolls. These actions would hurt consumer spending and, possibly, roll back many of the recent economic gains. A willingness to make investments, however, even in these uncertain times, could prevent further lost opportunities and allow Illinois and the Illinois workforce to comfortably weather an economic slowdown and prosper in the future.

# AN OVERVIEW OF THE ILLINOIS TAX SYSTEM

State tax systems are evolving rapidly. Personal income taxes have become relatively more important across the nation in the past two decades. At the same time, property taxes have declined in importance, as states have assumed a greater role in funding education and local government funding has diminished. Yet Illinois has bucked these trends, continuing to rely on regressive local property taxes as the primary source of funding for schools. This chapter examines the Illinois state and local tax structure in comparison to other states and looks at trends in Illinois tax revenues over the past two decades. We also estimate the distribution of state and local tax liability by income levels in 2000, and assesses the distributional impact of tax changes enacted in recent years.

## Total State & Local Taxes in 1999: Three Measures

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

### Addendum: Illinois as a % of National Average

<b>94.8%</b>	<b>95.5%</b>	<b>104.6%</b>
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SOURCE: Bureau of Economic Analysis; Bureau of the Census. GSP data is fiscal 1998.

## The Illinois Tax Burden: How High?

Several measures are frequently used for cross-state comparisons of tax burdens. Illinois's state and local tax burden can be seen as somewhat above average, or somewhat below average, depending on which of these measures is used.<sup>2</sup> In particular:

<sup>2</sup>All statistics presented here include both state and local taxes. Because states vary in the proportion of their revenues raised at different government levels (i.e., state versus local), limiting our analysis to only state (or only local) revenues would greatly distort the state-by-state comparisons. For an example of how the omission of local government revenues can skew state rankings, see "An Analysis of The Cato Institute's 'The Case Against a Tennessee Income Tax,' " (1999) Institute on Taxation and Economic Policy, at <http://www.ctj.org/itep/tncatoan.htm>.

State and local taxes include all taxes raised by state and local governments, mostly from property taxes, consumption taxes, personal income taxes, and corporate income taxes.

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

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

Each of these measures offers some insight, but each has its limitations as a measure of tax burden. For example, measuring taxes on a per capita basis tells us that Illinois residents pay more taxes per person than do residents of most states—but tells us nothing about *why* this is so. Various factors can explain different levels of state tax burdens, including differences in income levels, the cost of providing government services in the state, and the level of services demanded by the public. Since Illi-

nois residents enjoy higher per-capita income than any of the surrounding states (and had the eighth-highest per-capita income in the country in 1999), it should not be surprising that the state's per-capita tax burden is above average. Moreover, the per capita measure tells us nothing about the percentage of state tax revenue that is actually paid by

Illinois residents; many states use sales taxes and business taxes to export a substantial part of their aggregate tax burden. In states that rely heavily on such taxes, the per capita measure can significantly overstate the real tax burden facing state residents: for most years, the state with the highest state per-capita tax burden is Alaska, which raises more than half of its taxes through sources that are exported out of state, such as severance and corporate income taxes.

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

#### Taxes as a % of Own-Source Revenues

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

SOURCE: Bureau of the Census

### Tax-by-Tax Variation in 1999

While the aggregate Illinois tax burden is below average, there is considerable variation in the level of particular Illinois taxes: some taxes are comparatively quite low, while others are relatively high. The chart on this page shows various Illinois taxes as shares of personal income in fiscal 1999.

- While the Illinois personal income tax and consumption tax burden is comparatively

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

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

SOURCE: Bureau of Economic Analysis; Bureau of the Census

quite low, the property tax burden is relatively high. The personal income tax burden on Illinois residents was more than twenty percent below the national average in 1999—and the property tax burden was about twenty percent *above* the national average.

- Both personal income tax and consumption tax burdens rank, in the aggregate, in the lowest third of states nationally. The Illinois property tax burden is in the top third of states nationally.
- The Illinois personal income tax burden ranks substantially lower than that of all neighboring states. The total income tax burden in Illinois is just over half the income tax burden facing Wisconsin residents, and is 20 percent lower than the next-lowest neighboring state, Indiana.
- Of the 41 states that levied broad-based income taxes in 1999, only four states' income tax burden was lower than that of Illinois.
- Only Indiana has a lower aggregate consumption tax burden among neighboring states—and only Wisconsin has a *higher* aggregate property tax burden.<sup>3</sup>

The Illinois tax burden is even lower when non-tax revenues are taken into account. In 1999,

<sup>3</sup>One implication of this imbalance in the Illinois tax system is that substantial changes could be enacted without significantly raising the state's ranking. For example, if the Illinois income tax rate had been a flat 5 percent rather than 3 percent in 1999, the income tax would still have been below average in 1999.



Illinois ranked fifth nationally in the percentage of its own-source general revenues derived from taxes, with more than 75 percent of these revenues coming from taxes. This means that non-tax general revenues—primarily user fees on highways, sewers, education, hospitals and parks—represent an especially low share of Illinois state and local revenues compared to most other states. This also means that focusing only on tax revenues tends to overstate the cost of Illinois government compared to other states. Inclusion of non-tax own-source revenues drops the state’s revised tax burden even further, to 47<sup>th</sup> in the nation in fiscal 1999.

### Limitations of Aggregate Tax Data

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

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

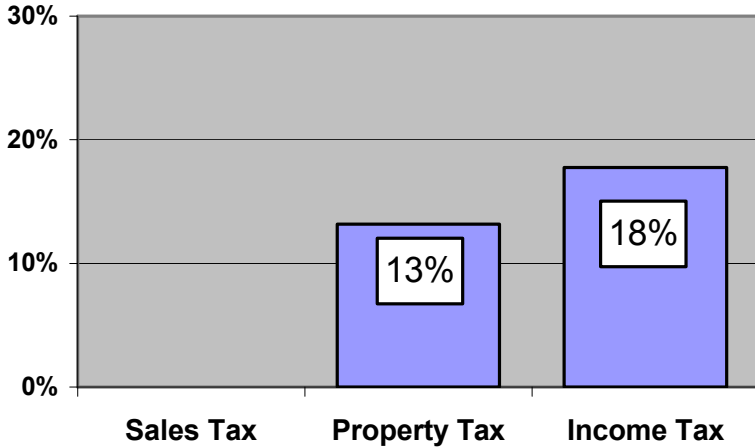
### The Importance of Interaction with the Federal Income Tax

The ability to deduct some taxes on federal income tax returns also affects comparisons of tax burdens between states. The more a state relies on deductible taxes (such as income and property taxes), the lower are the federal taxes paid by its citizens. The citizens of states relying more heavily on deductible taxes have lower total tax burdens—state, local *and* federal—than the residents of states relying more heavily on non-deductible taxes (such as the general sales tax). The following example shows the impact of federal deductibility on a family earning \$75,000. A state tax burden of \$3,300 composed entirely of non-deductible taxes has no effect on this family’s federal tax burden. But if the same family paid \$3,300 in federally deductible taxes, the federal tax burden on this family would decrease by about \$500—or 15 percent of the state tax bill this family paid. This is an important mechanism for exporting state taxes to the federal government—by allowing a deduction for state and local income and property taxes to decrease federal taxes, the federal government

The Impact on an Illinois Family with \$75,000 of Income of Paying Deductible Instead of Non-Deductible Taxes			
Deductible Taxes		Non-Deductible Taxes	
State Property Tax	\$ 1,400		
State Income Tax	1,900	Non-Deductible Taxes	\$ 3,300
Total State Taxes	3,300	Total State Taxes	3,300
Federal Income Tax	8,900	Federal Income Tax	9,400
<b>Total</b>	<b>\$ 12,200</b>	<b>Total</b>	<b>\$ 12,700</b>
<b>\$500 (15%) of deductible taxes is offset by federal tax cuts.</b>			

essentially subsidizes states that rely heavily on deductible taxes—and offers no assistance to states that rely only on non-deductible sales and excise taxes. In 2000, Illinoisans paid over \$2.9 billion less in federal income taxes because of the state’s reliance on deductible personal income and property taxes than they would have if the state relied entirely on non-deductible taxes. The chart on the next page shows the extent to which individual Illinois taxes were paid by the federal government in 2000 in the form of lower federal income taxes.

### How Illinois Exports its State Tax Burden to the Federal Government



### The Distribution of Illinois Taxes by Income Level

The following distributional chart takes into account the federal deductibility and exporting issues that the aforementioned aggregate data cannot address: the distributional chart estimates the net burden of Illinois taxes on Illinois residents at various income levels in 2000. The chart shows that the Illinois tax system is *regressive*: it requires middle- and lower-income residents to pay a greater share of their income in taxes than it does the wealthy. In 2000, the 20 percent of Illinois residents with incomes under \$15,000 paid 13.0 percent of their income in Illinois taxes. The middle 20 percent of Illinois residents, with average incomes of \$36,000, paid 10.0 percent of their income in Illinois taxes. The wealthiest one percent of Illinois residents—with average incomes of \$1.2 million in 2000—paid 6.0 percent of their income in Illinois taxes.

A regressive tax system is problematic because it places the largest tax burden on those with the least ability to pay taxes. A ten percent tax burden on middle- or low-income families cuts directly into their standard of living in a significant way. But a similar level of taxation on wealthy families does not as significantly impede their quality of life. This idea is the underpinning of the ability-to-pay principle—the

idea that wealthier taxpayers can more easily bear the cost of taxes than can lower-income taxpayers. A progressive tax system takes a *larger* percentage of the income of the well-off than it does from those with lower incomes. A regressive tax system—like that of Illinois—does exactly the reverse.

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

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

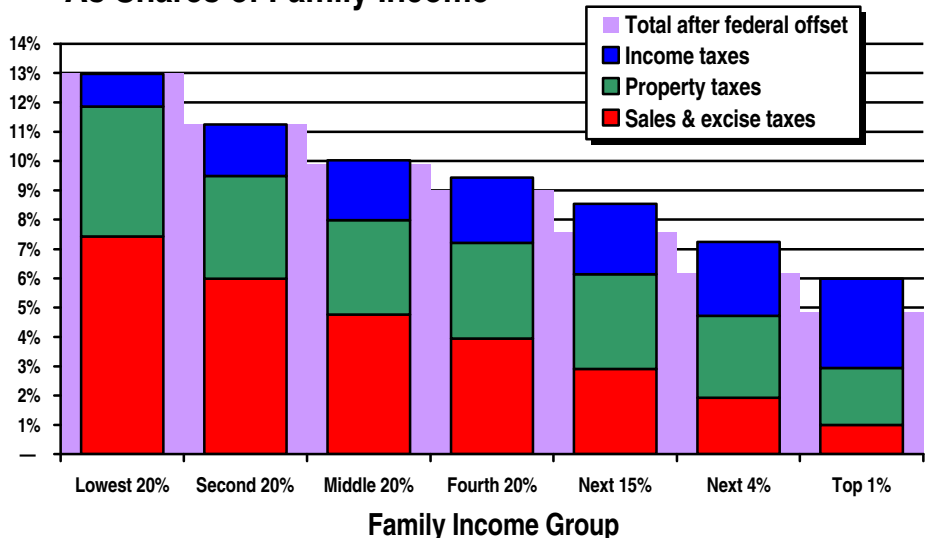
- Illinois property taxes are moderately regressive—but are substantially higher than property taxes in most states.

- Illinois consumption taxes, while not high in the aggregate, are quite regressive.

Most states rely more heavily on income taxes—and less heavily on property taxes—than Illinois. As a result, almost all state tax systems are less regressive than the Illinois system. A 1996 ITEP study found that the Illinois tax system was one of the ten most regressive in the nation.

The ITEP study also found that while the Illinois tax burden was relatively low, many Illinoisans did not experience Illinois as a low tax state at all: the tax burden on the poorest twenty percent of Illinoisans was eighth highest in the nation, while the tax burden on the wealthiest one percent was just 39<sup>th</sup>. In fact, the ITEP study found, the poorest 60 percent of married families in Illinois actually

### Illinois State and Local Taxes in 2000 As Shares of Family Income



faced a tax burden above the national average—while the wealthiest 40 percent of taxpayers paid a tax burden substantially *below* the national average.

### The Illinois Tax Burden in 1995: Low or High?

	Tax as %	
Income Group of Income		US Rank
Lowest 20%	13.6%	8
Second 20%	10.6%	15
Middle 20%	9.8%	23
Fourth 20%	9.2%	29
Next 15%	8.6%	30
Next 4%	7.2%	36
Top 1%	6.1%	39

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

For instance, the wealthiest one percent of Illinois taxpayers on average see their Illinois tax burden of 6.0 percent offset by a reduction in their federal taxes equal to 1.1 percent of their income. Thus, the net burden of the Illinois tax system on the wealthiest one percent is 4.9 percent of income—20 percent less than the nominal state tax burden. In contrast, for middle-income Illinoisans, the burden of Illinois taxes is cut by only 0.1 percent—from 10.0 percent to 9.9 percent. This represents just a 1 percent federal offset for this group.

Low-income Illinoisans, who rarely itemize federal income taxes, are unable to take advantage of the exportability of income and property taxes.

### Trends in Illinois Taxes

In the past two decades, total state and local taxes in Illinois have increased slightly as a share of personal income—but other states increased their tax burdens even faster. In 1979, total state and local taxes in Illinois were 10 percent of income, ranking Illinois 30<sup>th</sup> nationally. By 1999, Illinois's ranking had fallen to 35<sup>th</sup>, and the state's tax burden had risen slightly to 10.3 percent of personal income. The Illinois tax burden has remained below the national average throughout this period, and the state's ranking relative to its neighbors has remained generally unchanged. Expressed this way, the Illinois tax burden is substantially lower than the burden in Iowa, Kentucky, Michigan and Wisconsin, and is higher than the burden in Indiana and Missouri.

The Illinois tax system has also become less balanced. The state's reliance on regressive property taxes, already above average in 1979, has increased relative to other states during the past two decades.

- While the percentage of Illinois taxes derived from the property tax rose only moderately during the period from 1979 to 1999, many other states chose to decrease their reliance on property taxes during this period. As a result, the state's reliance on property taxes rose from 22<sup>nd</sup> nationally in 1979 to 9<sup>th</sup> nationally in 1999.
- In contrast, a moderate increase in the share of Illinois revenues derived from personal income taxes was swamped by a substantial trend towards income taxes nationally, with the result that the state's ranking in reliance

### Total Taxes as a % of Personal Income

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

SOURCE: Bureau of the Census, Bureau of Economic Analysis

on personal income taxes *dropped* from 28<sup>th</sup> to 35<sup>th</sup> from 1979 to 1999.

- The state's reliance on sales and excise taxes has decreased substantially; while consumption taxes represented more than 38 percent of total state and local tax collections in fiscal 1979, these taxes comprised only 32.6 percent of total taxes in fiscal 1999. By this measure, the state's reliance on consumption taxes fell from 25<sup>th</sup> in 1979 to 29<sup>th</sup> in 1999.

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

## Tax Changes Since 1997

Many states engaged in major tax reforms during the 1990s, including substantial tax hikes in the early years and a wave of tax cuts during the last five years of the decade. Previous ITEP research has shown that for some states, the net impact of these changes has been regressive.<sup>4</sup> This section examines the impact of major tax changes enacted since 1997 in Illinois.

By national standards, the tax changes enacted in Illinois during this period were relatively small in scope. In 1997 and 1998, lawmakers cobbled together tax hikes for education (in 1997) and transportation (in 1998) spending. These tax hikes focused almost entirely on regressive tax hikes in excise taxes, including alcohol, cigarette and telephone taxes. Lawmakers also passed a series of small, progressive income tax cuts, most of which were temporary. Finally, lawmakers passed temporary tax cuts in the form of a six-month suspension of the sales tax on gasoline and a one-time “property tax rebate” distributed to income-tax payers.

## 1997: School Funding Debate

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

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

As the table on the next page shows, these tax hikes were regressive in their impact—and completely bypassed the recommendations of the Commission on Education Funding. The important questions raised by the Commission about “property tax swap” options were left unanswered.

## 1999: Illinois FIRST

In 1999 the state legislature passed a five-year, \$12 billion capital development program, partially funded by increases in excise taxes and vehicle transfer fees. The major tax-related component of the plan was a 6-cent increase in the excise tax on beer, a 90-cent increase in the tax on distilled spirits, and a 15-cent increase in the tax on wine. These changes represented substantial tax hikes, doubling or tripling the tax rates on sales of various alcoholic beverages. And these changes were highly regressive in their impact, since alcohol consumption represents a larger share of income for low-income taxpayers.

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<sup>4</sup>*Pennies from Heaven? The Distributional Impact of Massachusetts Tax Cuts in the 1990s*, ITEP and the Tax Equity Alliance for Massachusetts (1998), available on the TEAM website at <http://www.massteam.org/itep.pdf>.

## 2000: Property Tax Rebates

The fiscal 2000 budget included both temporary and permanent tax relief measures. The largest component of the tax relief was a one-time property tax rebate. The Homeowners's Tax Relief rebate was equal to the amount of credit claimed by Illinois income-tax payers under the existing Property Tax Credit on the income tax form for tax year 1999, with one important modification—the credit was capped at \$300 per taxpaying household. This rebate was funded entirely by taking \$280 million from the Tobacco Settlement Recovery Fund, and transferring it to a new Homeowner's Tax Relief Fund. While the overall impact of the rebate was slightly progressive, it offered no tax relief to non-homeowners. Chapter Four of this report includes a more detailed analysis of the property tax rebate.

The same legislation also created a state Earned Income Tax Credit. The credit is unusual among the fifteen state EITCs in existence for tax year 2000 in that it is scheduled to be repealed on December 31, 2002.<sup>5</sup> The EITC is paid for by transferring \$35 million each year from the Tobacco Settlement Recovery Fund to the Income Tax Refund Fund. As described in Chapter Three, the usefulness of the current EITC is limited by its low rate—no state allows a credit of less than the 5 percent Illinois credit—and its nonrefundability, which means that taxpayers can only use the credit to reduce their income tax liability to zero—even if their tax burden from sales and excise taxes is substantial. Chapter Seven estimates the impact of expanding the state EITC.

The legislature also increased the income tax personal exemption from \$1,000 to \$2,000 over several years, and increased the maximum income level at which elderly taxpayers can claim the circuit breaker property tax credit. These progressive

## Major Illinois State Tax Changes, 1995-2000

### Fully Phased-In, 2000 Levels

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

### ADDENDUM: Temporary Tax Cuts

One-time Property Tax Rebate	-0.2%	-0.1%	-0.1%	-0.2%	-0.1%	-0.1%	-0.0%
Suspension of Sales Tax on Gasoline	-0.2%	-0.2%	-0.1%	-0.1%	-0.1%	-0.0%	-0.0%
<b>All Tax Changes:</b>	<b>-0.6%</b>	<b>-0.4%</b>	<b>-0.3%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.1%</b>	<b>-0.0%</b>

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

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

This analysis assumes that the tax cuts from the temporary gasoline sales tax cut were passed on to consumers. However, some observers argued that the sales tax cut was often not passed through at all.

**Source:** Institute on Taxation and Economic Policy Microsimulation Tax Model, February 2002

changes were fully effective in tax year 2000.

### The Whole Story?

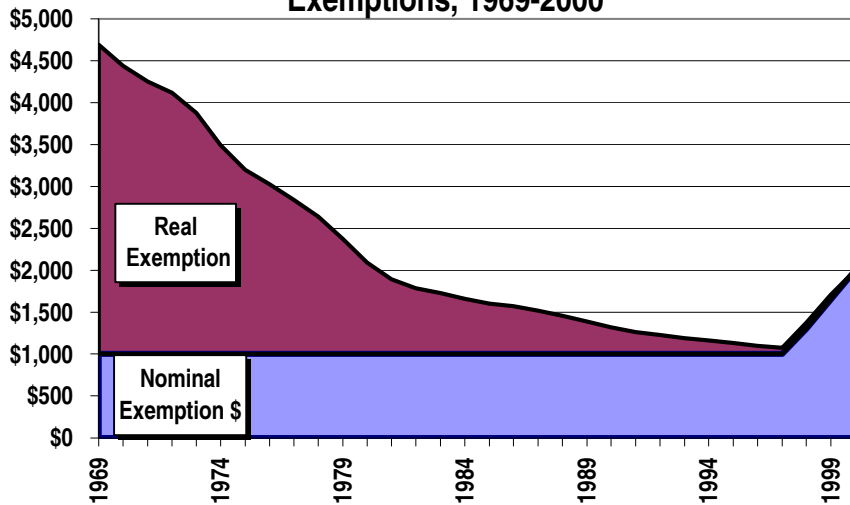
The data presented above suggest that even as lawmakers have enacted substantial increases in various excise taxes, they have passed income tax cuts which offset the regressive effects of the excise tax increases. However, these results present an incomplete picture of changes in the Illinois tax structure for two reasons.

First, these figures here show only the *statutory* changes enacted in recent years. This approach does not account for tax hikes that are due to inflation. For example, the real value of the personal exemption has been gradually losing its value since 1969, when the income tax was introduced. The inflation-adjusted current value of the \$1,000 exemption that was introduced in 1969 was \$4,700. By doubling the personal exemption from \$1,000 to \$2,000, lawmakers have actually offset less than half of the inflationary *decline* in the value of the

<sup>5</sup>The Illinois approach is not unique, however. Indiana and Colorado have also enacted low-income tax credits that are temporary (in the case of Indiana) or dependent on fiscal surpluses (in the case of Colorado).



### The Declining Real Value of Illinois Personal Exemptions, 1969-2000



exemption. over the past thirty years. Chapter Three of this study explores this problem at more length—and Chapter Four shows that the recent expansion in circuit breaker eligibility has been more than offset by inflationary losses in the value of the circuit breaker.

Second, the data presented here do not take into account *local* tax changes that are not mandated by the state. As documented in Chapter Five of this study, local governments in Illinois sharply increased their use of local-option sales taxes during the 1990s. An ongoing ITEP study, to be released in the spring of 2002, will systematically compare the effect of *all* tax changes in Illinois and each other state during the 1990s.

### Conclusion

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

The most common topic of discussion among Illinois tax policy makers during the 1990s was the best way to achieve what some observers saw as an inevitable tax shift from heavy reliance on local property taxes to a higher reliance on state income taxes as a source of funding for state and local services. Yet the series of relatively small tax changes that have been enacted in the past several years have done nothing to advance this cause. All of the substantial tax changes enacted since 1997 have focused on regressive excise tax hikes—and while major property tax relief legislation was enacted during the 2000 legislative session, the enacted tax relief was temporary, partially regressive

in its impact, and limited to those with personal income tax liability.

Moreover, changes enacted in the personal income tax structure during this period—while progressive enough to roughly offset the impact of the recent excise tax hikes—have done nothing to systematically increase the role of the income tax in the state’s revenue system. And the recent expansion of the state’s personal exemption is best understood not as a tax cut, but as a partial offset for the gradual, long-term tax increase that has been enacted due to the slowly declining value of the exemption.

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—and have not reduced the regressivity of the tax structure significantly.

# THE ILLINOIS PERSONAL INCOME TAX

Illinois has a very low income tax. Only four states levy income taxes that take a smaller share of income than Illinois. Yet Illinois's tax burden on the very poorest Illinoisans is higher than most states. Illinois's flat-rate structure and its poorly targeted exemptions and credits reduce the yield and progressivity of the tax, and fails to take advantage of the interaction between state and federal taxes. Perhaps most important, the low-yield, low-fairness structure of the tax stands as a roadblock to the state's ability to provide meaningful low-income tax relief while funding important government services.

## A Low Income-Tax State

As noted, Illinois's personal income tax burden is lower than that of most other states levying such a tax. In 1999, Illinois personal income taxes represented 2.0 percent of personal income, ranking the state 37<sup>th</sup> nationally. Among the 41 states levying broad-based income taxes in 1999, only four states imposed a lower personal income tax burden.<sup>6</sup>

While the Illinois income tax burden has grown somewhat over the past two decades, other states have, on average, increased their income tax reliance even faster. Since 1979, Illinois's personal income tax burden has fallen from 29<sup>th</sup> in the nation to 37<sup>th</sup>. Similarly, while Illinois has increased the percentage of its total tax revenues that come from income taxes, other states have done so at a faster rate. As a result, the income tax burden, 17 percent below the national average in 1979, is now 21 percent below the national average.

## Burdens and Trends in Illinois Income Taxes

	As a % of Personal Income				As % of Total Taxes			
	1979	US Rank	1999	US Rank	1979	US Rank	1999	US Rank
Illinois	1.6%	29	2.0%	37	15.6%	29	19.1%	36
Indiana	1.4%	35	2.8%	18	15.9%	28	27.1%	17
Iowa	2.2%	17	2.4%	33	21.5%	14	22.9%	32
Kentucky	2.4%	11	3.6%	8	23.8%	10	33.0%	4
Michigan	2.5%	9	2.7%	22	22.4%	12	25.0%	23
Missouri	1.6%	27	2.7%	21	18.0%	23	27.5%	15
Wisconsin	3.4%	6	3.7%	6	28.5%	4	29.6%	11
<b>ALL STATES</b>	<b>1.9%</b>		<b>2.5%</b>		<b>17.9%</b>		<b>23.2%</b>	
<b>IL as % of US avg</b>	<b>83%</b>		<b>79%</b>		<b>87%</b>		<b>82%</b>	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

## A Narrow Tax Base

Like most states, Illinois ties its income tax base directly to federal adjusted gross income (AGI) as determined on federal income tax forms. By adopting federal AGI as its starting point for state income tax purposes, Illinois automatically excludes some forms of income from taxation. For example, federal AGI does not include most Social Security benefits, welfare benefits, gifts and bequests, medical savings accounts, alimony paid, student loan interest, and education IRAs. In addition, Illinois taxpayers must make several Illinois-specific adjustments to federal income to arrive at Illinois adjusted gross income. Illinois AGI differs from federal AGI in the following important ways:

- All federally taxable Social Security benefits are exempt from taxation in Illinois.
- All public and private pension benefits—including those benefits which are taxable on the federal level—are exempt from Illinois income taxation.
- Unemployment compensation, taxable on the federal level, is exempt in Illinois.

Several other Illinois-specific tax preferences further reduce the amount of Illinois income subject to income tax.

<sup>6</sup>These states were Arizona, Louisiana, North Dakota, and Mississippi.

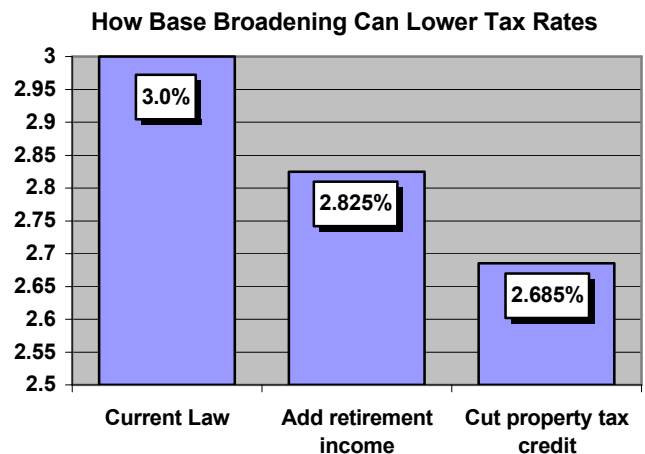
## Taxation of Personal Income in Illinois

<b>Total Taxpayer Income</b>
Minus
<b>Federally Exempt Income</b> (Some Social Security benefits, welfare benefits, gifts)
Equals
<b>Federal Gross Income</b>
Minus
<b>Federal Adjustments</b> Medical Savings Accounts, Alimony, Moving Expenses, Student Loan Interest
Equals
<b>Federal Adjusted Gross Income</b>
Minus
<b>Illinois Subtractions</b> Federally Taxable Social Security Benefits, Federal Interest
Plus
<b>Illinois Additions</b> Federally Tax-Exempt Interest and Dividend Income
Equals
<b>Illinois Base Income</b>
Minus
<b>Personal Exemptions</b> (\$2,000 per federal exemption plus \$1,000 for elderly)
Equals
<b>Illinois Taxable Income</b>
Multiplied by
<b>3 percent tax rate</b>
Equals
<b>Tax Before Credits</b>
Minus
<b>Tax Credits</b> Earned Income Tax Credit, Property Tax Credit, Tuition Credit
Equals
<b>Net Tax Liability</b>

- Taxpayers are allowed personal exemptions of \$2,000 for each exemption claimed on the federal income tax form.
- A series of tax credits are available for eligible taxpayers, including the Earned Income Tax Credit, the property tax credit and the education expense credit.

The net impact of these exclusions and credits is to narrow the Illinois income tax base considerably—and to reduce the yield of the income tax for each percent of income that is taxed. The following chart shows graphically the importance of these exclusions: in 2000, a 3 percent rate was sufficient to raise \$7.9 billion in revenues. In the absence of pension and Social

Security benefit tax breaks, the tax rate could be lowered for all taxpayers to 2.825 percent with the same state revenue yield. If, in addition, the state's property tax credit were repealed, the Illinois tax structure could raise the same amount with a rate of 2.685 percent in tax year 2000. In other words, each income tax exclusion granted by lawmakers increases the rate that must be applied to everyone else's taxable income. The narrower the base, the higher the tax rate must be in order to raise a given amount of income. And the broader the base, the lower the rate can be.



## A Progressive Income Tax?

The Illinois income tax, taken by itself, is slightly progressive: low-income taxpayers pay, on average, 1.0 percent of their income in Illinois income taxes, less than the percentage paid by all higher-income groups. Taxpayers in the middle 20 percent of the income distribution pay 2.1 percent of their income in state income taxes, and the top one percent of Illinois taxpayers pay 2.6 percent of their income in state income taxes. Yet this modest degree of progressivity is dwarfed by the progressivity of most other states' income taxes.<sup>7</sup> 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 best-off 40 percent of the population. That is, the wealthiest one percent of taxpayers—with an average income of \$1.2 million—pays *less* in state

<sup>7</sup>One of the findings of ITEP 1996 study, *Who Pays*, was that the Illinois income tax was less progressive than all but 3 of the 41 states levying broad-based income taxes. (The study measured the incidence of taxes on married non-elderly taxpayers in all 50 states.)



income taxes, after the federal offset, than do taxpayers in the fourth quintile—a group with an average income of \$59,000.

The minimal progressivity of Illinois’s income tax has important implications for the state’s overall tax structure. Since income taxes are typically the only major progressive tax levied by states, a flat-rate tax will do little or nothing to offset the inherent regressivity of the other major state and local taxes—consumption and property taxes. In fact, a central finding of ITEP’s 1996 study, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, was that Illinois has one of the ten most regressive tax systems in the nation—largely because the income tax failed to offset the regressivity of the non-income tax burden.

### Factors Limiting the Progressivity of the Illinois Income Tax

The limited progressivity of Illinois’s income tax is the product of several uncommon features of the state’s tax structure. Most notably:

- Illinois is one of only six states to tax income at a **flat rate**.
- The state’s **personal exemption** is relatively low, and is not currently indexed for inflation. And unlike most states, Illinois does not allow a **standard deduction**.
- The various **deductions and credits** offered by Illinois tend to favor higher-income taxpayers.

#### Flat Rate

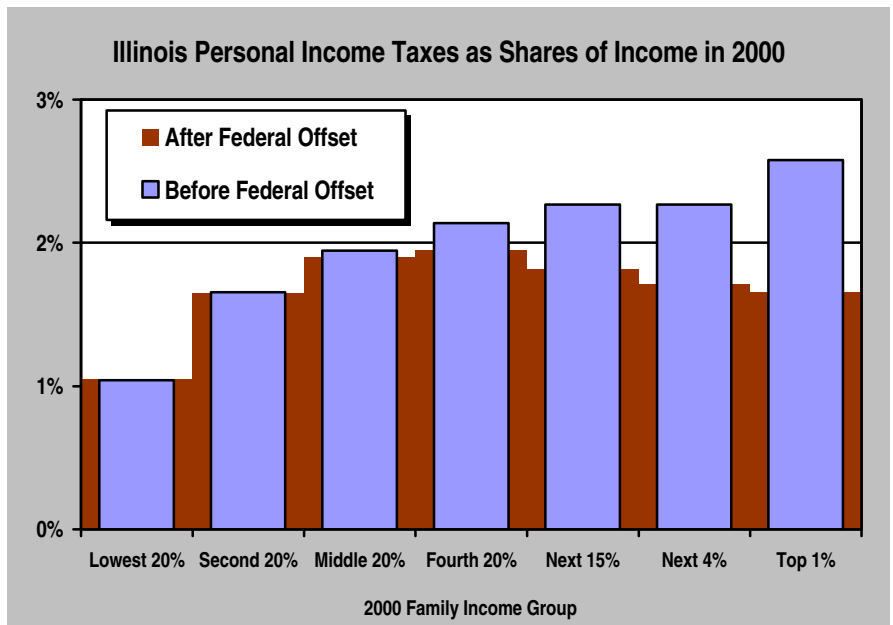
The principal reason for the lack of progressivity in Illinois’s income tax is its low, flat rate structure. Illinois is one of only six states nationally to impose a broad-based income tax at a single flat rate. Of these states, only Pennsylvania has a lower tax rate.

The choice to levy a flat-rate tax has several consequences, none of them beneficial.

First, by taxing the

#### Flat-Rate Personal Income Taxes in 2001

State	Rate
Massachusetts	5.6%
Colorado	4.75%
Michigan	4.2%
Indiana	3.4%
Illinois	3.0%
Pennsylvania	2.8%



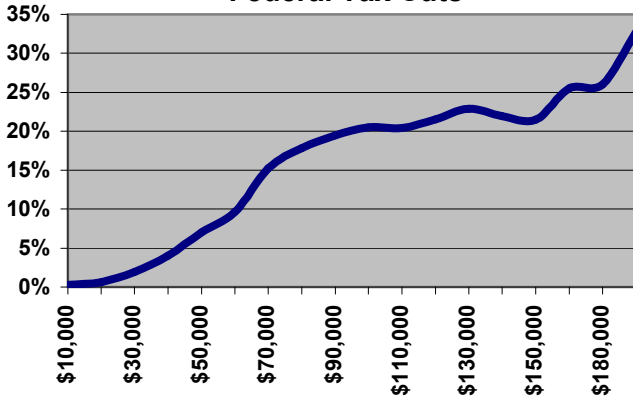
income of even the wealthiest taxpayers at the same rate as the poorest workers, it does not account for differences in ability to pay between poor and wealthy taxpayers.

Second, because the fastest income growth tends to take place among high-income taxpayers, flat-rate income taxes tend to grow very slowly—and can even grow more slowly than the economy.

Third, flat-rate taxes place a greater share of the burden on low-income taxpayers who cannot export part of their income tax to the federal government through itemized deductions. Progressive income taxes, on the other hand, apply a greater share of the burden to wealthier taxpayers—which means that a larger share of the tax is ultimately paid by the federal government.

The following chart shows the relationship between state income taxes and federal tax deductions as income increases. For low-income taxpayers, who rarely itemize, little or none of the state income tax burden is offset by federal tax deductions. At the very highest income levels, more than a third of state income tax liability is paid not by Illinois taxpayers but by the federal government. This means that Illinois policymakers can export a greater percentage of the state income tax burden out of state by cutting the tax paid by low-income Illinoisans. More so than most states, Illinois relies on income tax payments from low-income taxpayers. By doing so, Illinois policy makers miss an opportunity to export a substantial part of the state tax burden to the federal government.

### % of State Income Tax Offset By Federal Tax Cuts



### Small Personal Exemptions

When the Illinois income tax was enacted in 1969, the personal exemption was set at \$1,000. The value of the exemption was left unchanged until 1998, when the legislature passed a bill doubling the exemption over three years. In tax year 2000, Illinois taxpayers could claim a personal exemption of \$2,000 for each exemption claimed on the federal income tax,<sup>8</sup> with an extra \$1,000 for each taxpayer who is over 65 or legally blind. While doubling the exemption has increased the fairness of the state income tax, the 1998 legislation has not been enough to offset a substantial decline in the real (inflation-adjusted) value of the exemption over time. The original personal exemption of \$1,000 was actually worth almost \$4,700 in today's dollars. This means that the current \$2,000 personal exemption is worth less than half of the real value of the exemption enacted in 1969. In other words, inflation has inflicted a hidden tax hike that policymakers would never seriously consider—a 50 percent cut in the personal exemption available to Illinois taxpayers. This constitutes a substantial—and regressive—income tax hike. Illinois taxpayers paid \$770 million more in taxes in 2000 than they would have if personal exemptions had been indexed since 1969, and low-income Illinoisans bore the brunt of this tax hike.

Because the real value of the state's personal exemption has declined—and because the state does not allow a standard deduction—more of the income of poor families in Illinois is subject to

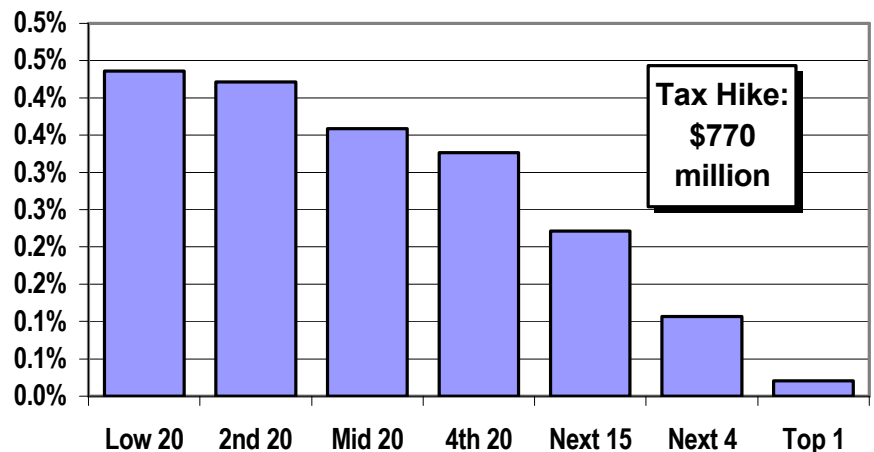
<sup>8</sup>Married joint filers are allowed a total of \$4,000 in personal exemptions.

income taxation 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 2000 tax threshold—the amount of income that is shielded from taxation through standard deductions, personal exemptions and low-income credits—was lower in Illinois than in all but nine other states.<sup>9</sup> The study found that Illinois is one of only nineteen states that imposes income taxes from two-parent families of four earning less than the poverty level in 2000.

### Targeted Income Tax Breaks

This is not to say that Illinois lawmakers have been stingy in enacting income tax loopholes. On the contrary, policymakers have enacted a host of poorly targeted and expensive tax credits and deductions which erode the income tax base without providing meaningful low-income relief. Among the most expensive such provisions are a recently enacted tax credit for education expenses, exclusions for pension and Social Security benefits, and a homeowner property tax credit.

### Real Exemption Cuts Due to Inflation, 1969-2000 Tax Change as % of Income



<sup>9</sup>State Income Tax Burdens on Low-Income Families in 2000: Assessing the Burden and Opportunities for Relief. Bob Zahradnik, Nicholas Johnson, Michael Mazerov (2001). This ranking actually represented a substantial improvement for Illinois over the previous year, when the state taxed these families at a lower level than all but three other states. The improvement was entirely due to the state's enactment of an Earned Income Tax Credit for tax year 2000. If the EITC is allowed to sunset in 2003 (as the enacting legislation provides), the state's ranking will decline again.

### Education Expense Credit

In 1999, the Illinois legislature enacted a school tuition subsidy in the form of a non-refundable credit against educational expenses (such as tuition, book fees and lab fees) in excess of \$250. The credit is calculated as 25 percent of expenses over \$250, with a maximum credit of \$500. Two features of the Illinois credit act to minimize its usefulness for low-income families: the restriction of the credit to expenses over \$250 per year and the non-refundability of the credit.

- More than half of the poorest Illinois families with children are ineligible for the education credit. That's because, of the 12 percent of Illinois families with children earning less than \$15,000 in 2000, 53 percent have no income tax liability after the property tax credit and they are thus ineligible for any education credit. Virtually none of these low-income taxpayers paid enough income taxes in 2000 to be eligible for the maximum education credit of \$500.
- The \$250 minimum expense requirement means that most families with children in public schools will probably be ineligible for the credit as well. In a suit challenging the constitutionality of the Illinois education credit in the fall of 2000, plaintiffs estimated that public school students pay tuition, book fees and lab fees of less than \$40 per student, on average.
- Since better-off families are much more likely to send their children to private schools, the \$250 minimum requirement acts to tilt the distribution of the tax cuts in favor of wealthier taxpayers with children.

In addition, the education credit is estimated to be quite costly: it reduced income tax collections by over \$60 million in tax year 2000. By comparison, \$60 million could have funded a \$1000 income tax credit for each child under age 12.

## Families with Kids Ineligible for the Education Credit

### Illinois Families with Children in 2000

Income Range:	% of Returns	% With No PIT Liability	% With Positive PIT Liability <\$500	% Unable to Claim Maximum Credit
Under \$15,000	12%	53%	47%	100%
\$15,000 to \$30,000	17%	7%	64%	71%
\$30,000 to \$50,000	19%	2%	11%	13%
\$50,000 to \$75,000	22%	0%	2%	2%
\$75,000 to \$100,000	12%	0%	0%	1%
\$100,000 to \$200,000	13%	0%	0%	0%
Over \$200,000	4%	0%	0%	0%

**Notes:** The credit provides a maximum tax credit of \$500 per family in 2000. Only expenses over \$250 can be claimed toward the credit. This means that only families with annual education expenses of \$2,500 (\$2,250 of eligible expenses, plus the first \$250 of expenses, which are ineligible for the credit) are eligible for the maximum credit.

### Social Security Exclusion

Under federal tax rules, most Social Security recipients pay no income tax on their benefits. At higher income levels, however, a portion of benefits becomes taxable. The rules are somewhat complicated, but, for example, a couple with \$20,000 in Social Security benefits, pays no federal income tax on its benefits unless the couple's total income exceeds \$42,000. Above that income level, a growing portion of Social Security benefits are subject to tax. Thus, a couple making \$50,000, including \$20,000 in Social Security benefits, would report 20 percent of its benefits in its taxable income; half of benefits must be reported if total income equals \$59,000; and 85 percent of benefits (the maximum) are included in taxable income when total income exceeds \$67,000.<sup>10</sup>

Illinois goes far beyond the federal rule by exempting *all* Social Security benefits, even for the best-off people. This full exemption for Social Security benefit is both regressive and costly.

- The best-off ten percent of elderly Illinois taxpayers get more than half the tax savings from Illinois's expanded exclusion, while the

<sup>10</sup>For a single person getting \$10,000 a year in Social Security benefits, none of the benefits are taxable until total income exceeds \$30,000. At \$34,000 in total income, 20 percent of benefits are taxable; at just under \$40,000, half of benefits are included in taxable income; and above \$44,000 in total income, 85 percent of benefits (the maximum) must be reported as taxable income.

## Retirement Income Exclusions

	Pension	Social Security
<b>Illinois</b>	<b>All exempt</b>	<b>All exempt</b>
Iowa	\$5,000 (\$10,000 married filing jointly)	Federal pre-1993 rules
Indiana	\$2,000 exempt	All exempt
Kentucky	\$35,000 private, full exemption for public	All exempt
Michigan	\$32,880 private, full exemption for public	All exempt
Missouri	\$6,000 means-tested exemption	Federal pre-1993 rules
Wisconsin	None Exempt	Federal pre-1993 rules

poorest half of elderly Illinois residents get nothing.

- Only 26 percent of Illinois Social Security beneficiaries would pay Illinois income tax on their benefits if the special Illinois exemption were repealed—which means that only 26 percent of elderly taxpayers receive a break from the Illinois exemption.
- Of the 70 percent of elderly Illinois taxpayers earning less than \$50,000 in 2000, only about 5 percent receive a tax break from the Illinois exemption.

### Other Pension Benefits

Illinois is quite generous in its tax treatment of private and public pension income other than Social Security benefits. Alone among Midwestern states levying an income tax, Illinois exempts all pension income from taxation. This blanket exemption creates two glaring problems of equity: first, it provides a special exemption to elderly taxpayers at all income levels. The pension benefits of the wealthiest executive receive the same favored treatment as do the benefits of the lowest-paid worker. A second, more fundamental inequity in this approach to elderly tax relief is that it provides special treatment for non-working taxpayers, with no comparable exemption for the earned income of otherwise identical seniors. Over-65 workers who are employed out of necessity are completely excluded from this generous tax break. Since

elderly Illinoisans who work tend to be poor, this tax preference for unearned income—with no corresponding preference for earned income—is hard to justify. Chapter Seven of this report shows that a revenue-neutral change eliminating these tax preferences and using the revenue to increase elderly exemptions would cut taxes for 60 percent of elderly taxpayers, and would *cut* federal income taxes paid in Illinois by \$35 million.

These poorly targeted exclusions reduced Illinois income tax collections by over \$500 million in 2000—and the gradual aging of the Illinois population suggests that as retirement benefits become an increasingly large component of total personal income in Illinois, the blanket exemptions granted to pension and Social Security income under the state’s tax code will force the state to turn to the other, currently taxed sources of personal income for additional revenues. In addition to creating a source of inequity between elderly taxpayers whose income is derived from these preferred sources and those whose income takes the form of wages, these preferences also discriminate against low-income taxpayers under the age of 65—and make it more likely that future income tax hikes will fall disproportionately on the non-elderly.

### A Low Income-Tax State—But for Whom?

This chapter has presented data suggesting that for the population as a whole, the Illinois income tax burden is one of the lowest among states levying such a tax. But the lack of progressivity in the income tax means that the state’s income tax burden ranking varies substantially by income

<b>Effect of Eliminating Pension and Social Security Benefit Preferences</b>				
Elderly Illinois Residents by Income Group, 2000				
Income Range	% of taxpayers in group	Average Income	% of Tax Hike From Taxing:	
			Pensions	Social Security
Below \$15,000	22%	\$ 10,000	0.6%	0.0%
\$15,000-\$30,000	28%	\$ 22,000	10.5%	0.1%
\$30,000-\$50,000	20%	\$ 38,000	21.8%	4.6%
\$50,000-\$100,000	19%	\$ 69,000	42.1%	40.2%
\$100,000 or more	10%	\$ 307,000	25.1%	55.1%
<b>Addendum: Bottom 50%</b>		<b>\$ 16,000</b>	<b>11.0%</b>	<b>0.1%</b>

group. The rankings in the next table compare the income tax systems of Illinois and its surrounding states. Specifically, the table looks at how Illinoisans at various income levels fared under Illinois’s actual 2000 income tax compared to how they

hypothetically would have fared had the income tax laws of Illinois's six closest neighbors applied instead. The numbers show tax burden *rankings*, from highest to lowest, as shares of income for each income group under each of the seven different income tax systems. The results are striking.

### State Tax Burdens in Midwest Taxpayers in 2000

Tax Burden on Illinois Taxpayers in 2000

	IL	KY	IA	MO	IN	WI	MI
Lowest 20%	2	3	4	7	1	6	5
Second 20%	6	1	4	7	2	3	5
Middle 20%	7	2	3	6	4	1	5
Fourth 20%	7	2	3	4	5	1	6
Next 15%	7	2	3	4	6	1	5
Next 4%	7	2	3	4	6	1	5
Top 1%	7	2	1	3	6	4	5
<b>All Taxpayers</b>	7	2	3	4	6	1	5
<b>% of tax paid by poorest 20% (Rank)</b>	1	3	4	7	2	6	5

SOURCE: ITEP Tax Model

While the total Illinois income tax burden ranks seventh—dead last—in this group of seven states, the state's income tax burden on the poorest fifth of Illinoisans is second *highest*, trailing only Indiana. By contrast, Wisconsin's total income tax burden is the highest among the seven, but nevertheless places the second *lowest* income tax burden on the poorest taxpayers. None of the surrounding states' income tax systems would require the very poorest Illinoisans to pay as large a share of the state income tax burden as they pay under Illinois's actual income tax system.

These results are similar to the findings of ITEP's 1996 study, *Who Pays*, which found that the total Illinois income tax burden on Illinoisans was 39<sup>th</sup> in the nation—but that the state's income tax burden on the lowest quintile was 13<sup>th</sup> nationally. The ITEP study also found that only three other states derived a greater percentage of their income tax collections from low-income families in 1995.

### A Low-Growth Tax

The overall regressivity of the Illinois income tax has consequences beyond its direct effort on lower-income tax burdens: it also depresses the overall growth rate of the tax—which makes it harder for Illinois to provide state services in times of fiscal crises. The Illinois income tax grows more slowly than almost every other state income tax.

Controlling for the effects of legislated income tax changes, one study found that the long-term growth rate of the Illinois income tax was the lowest in the nation during the period from 1976 to 1995.<sup>11</sup> In general, flat-rate-income-tax states experience slower income tax growth than more progressive states. This is because progressive income taxes place relatively higher tax burdens on the wealthiest taxpayers—and most of the recent growth in personal income has been concentrated at the top of the income scale. States that tax their wealthiest citizens at lower or flat rates, like Illinois, are less able to keep their tax collections up with personal income growth in the form.

Under a progressive rate structure, for each dollar of growth in personal income, *taxable* income generally grows by a greater amount than under a flat rate structure. This is because at some level, additional personal income becomes subject to tax at a higher rate.

In general, the best way to keep personal income tax revenues stable over time is to broaden the base as much as possible. Certain components of income—in particular, retirement income, which isn't affected by economic downturns—tend to be quite stable over the business cycle, and excluding these components of income from the income tax base adds to the instability of the tax.

The chart on the next page shows ITEP's estimate of the natural growth rate of the Illinois tax during the 1990s under 2000 law and under several alternative scenarios: that is, the chart shows the difference between the yield of the income tax as it actually existed in tax year 2000 and the amount of revenue the same tax structure would have yielded in 1989. The percentage growth we see for each tax measures the ability of the tax to grow with personal income, independent of any enacted tax changes. For example, if the 2000 income tax structure had been entirely unchanged during the 1990s, the income tax as a percentage of income would have increased by 6 percent. If the Illinois structure had been modified to eliminate either of the retirement income exclusions throughout the decade, the natural growth rate would have increased to 7 percent, and increasing the flat rate

<sup>11</sup>Dye, Richard F., and Therese J. McGuire, 1998. "Block grants and the sensitivity of state revenues to recession." *1997 Proceedings of the National Tax Association*. Washington DC. Dye and McGuire found that the Illinois tax had a long-term elasticity of 0.95.



to 5 percent would have had the same effect. By contrast, eliminating the state's Earned Income Tax Credit would have *diminished* the growth rate of the Illinois income tax, because incomes grew most slowly among taxpayers receiving the credit.

**Factors Affecting the "Natural Growth" of the Illinois Income Tax, 1989-2000**

	<b>Growth as % of Personal Income</b>
2000 tax structure	6%
Tax Social Security	7%
Tax Pensions	7%
Tax at 5% Rate	7%
No EITC	5%
3-rate graduated structure	16%

**Note:** This chart shows the growth in income tax revenues if different tax systems were imposed, without changes, for the entire period from 1989 to 2000.

The most notable feature of these results is the relatively small difference that base expansion makes for the existing Illinois tax. Taxing Social Security and pensions—both fast-growing components of personal income—would have only marginally increased the natural growth rate of the Illinois tax during the 1990s. The only change modeled here that affects the growth rate of the tax system meaningfully is the imposition of a graduated rate structure. The “3-rate graduated structure” line in the table shows the natural growth rate of the three-rate graduated income tax modeled in as Option 1 in Chapter Seven. If this tax structure had been in place throughout the 1990s, the natural growth rate of the Illinois income tax would have been more than 16 percent—more than double the natural growth of the existing flat tax.

It is important to note that the faster growth inherent in the graduated tax does not imply that the income tax burdens of all Illinoisans would grow equally fast under the graduated tax. In fact, 60 percent of Illinois taxpayers would have had a lower income tax burden in 2000 if the faster-growing 3-rate tax in Option 1 had been in place throughout the 1990s. Only 20 percent of taxpayers would actually be paying more in income taxes in 2000 under this alternative.

**Approaches to Income Tax Relief**

In recent years, many states have moved to decrease the income tax burden paid by low-income taxpayers. The inclusion of poverty-stricken taxpayers in the income tax rolls, once the rule among states levying such taxes, is now the exception.<sup>12</sup> Two of the most common strategies for low-income tax relief employed by states are low-income credits such as the Earned Income Tax Credit and dependent care credits, and indexing features of the income tax for inflation.

**Earned Income Tax Credit**

An increasingly popular means of achieving state tax relief for the working poor is an Earned Income Tax Credit (EITC). The federal EITC is designed to provide targeted tax relief to low-income working taxpayers. Because it is calculated as a percentage of earned income, the EITC acts as a work incentive for low-income taxpayers. In tax year 2000, fifteen states allowed a state EITC modeled on the federal credit. Most of these state credits are, like the federal credit, *refundable*. This means that low-income taxpayers are paid back any EITC in excess of their pre-credit tax liability. Thus, the EITC

**State Earned Income Tax Credits in 2000**

	<b>Credit</b>	<b>Refundable?</b>
Colorado	10%	Yes
D.C.	10%	Yes
<b>Illinois</b>	<b>5%</b>	<b>No</b>
Iowa	6.50%	No
Kansas	10%	Yes
Maine	5%	No
Maryland	50%	No
Massachusetts	10%	Yes
Minnesota	15 to 46%	Yes
New Jersey	10%	Yes
New York	22.5%	Yes
Oregon	5%	No
Rhode Island	26%	No
Vermont	32%	Yes
Wisconsin	4-43%	Yes

**Notes:** Maryland also allows a refundable 10% credit. The Massachusetts credit will increase to 15% in 2001. The New Jersey credit will increase to 20% in 2003. The New York credit will increase to 30% in 2003.

<sup>12</sup>State Income Tax Burdens on Low-Income Families in 2000: Assessing the Burden and Opportunities for Relief . Center on Budget and Policy Priorities, 2000.

mitigates the effect of regressive sales and excise taxes on low-income taxpayers. Because the benefits of the EITC phase out above a specified income level, the credit is targeted to the working families who need it most, and the cost of the credit is kept to a minimum. Six states—including Illinois—allow only a *nonrefundable* credit, which means that the credit claimed cannot exceed income tax liability in a given year. Non-refundability limits the usefulness of the EITC as a work incentive for those with low incomes, as most have little or no income tax liability. Because the Illinois credit is nonrefundable, many low-income taxpayers receive less than the full amount of the credit.

The Illinois credit, enacted in 1999 for tax year 2000, is scheduled to sunset after tax year 2002. While this sunset is unusual among state EITCs, it will allow the state legislature to reconsider the generosity of the state credit over the next two years.

### Dependent Care Credit

As an increasing number of single parents take jobs—and as the number of two-earner families continues to increase—the increasing cost of child care may act as a work disincentive for these families. Since 1982, the federal government has attempted to reduce this disincentive by providing a tax credit for income-tax payers who incur costs of dependent care. The federal credit allows taxpayers to claim as much as 30 percent of these costs as a nonrefundable credit against income tax. The federal credit is a sliding-scale percentage of eligible expenses,<sup>13</sup> starting at 30 percent of expenses and gradually decreasing to 20 percent as income rises. Taxpayers at all income levels are available for the 20 percent credit. Because the federal credit is nonrefundable (that is, it can only be used to reduce federal income tax liability), its usefulness for low-income taxpayers is limited; because the credit is available even to the wealthiest taxpayers, its cost is somewhat higher.

In recent years, many states have enacted piggyback credits that start with the federal definition of eligible child care expenses and apply a lower percentage. Some states have also modified the federal credit by making it refundable—so that lower-income taxpayers with child care costs can take full advantage of the credit—and by instituting

<sup>13</sup>Eligible expenses are limited to \$4,800 for joint filers and \$2,400 for single parents.

an income eligibility cutoff. Chapter Seven shows the cost and distributional impact of enacting a dependent care credit in Illinois.

### States Indexing Their Tax Structure in 2000

State	Standard Deduction	Exemption/ Credit	Rate Brackets
Arkansas	N	N	Y
California	Y	Y	Y
Colorado	Y	Y	N*
Idaho	Y	Y	N
Iowa	Y	N	Y
Maine	Y	Y	Y
Michigan	N**	Y	N*
Minnesota	Y	Y	Y
Missouri	Y	N	N
Montana	Y	Y	Y
Nebraska	Y	Y	N
New Mexico	Y	Y	N
North Dakota	Y	Y	N
Ohio	N**	Y	N
Oregon	N	Y	Y
Rhode Island	Y	Y	Y
South Carolina	Y	Y	Y
Utah	Y	Y	N
Vermont	Y	Y	Y
Wisconsin	Y	N	Y
States Indexing	16	16	11

#### Addendum:

States (including DC) with Broad-Based Income Taxes: 42

\* Levies a flat-rate income tax; indexing not possible

\*\*Does not allow a standard deduction

### Indexing for Inflation

Many features of personal income taxes are defined by fixed dollar amounts. For instance, a single Illinois taxpayer can claim a personal exemption of \$2,000 in tax year 2001. If these fixed amounts aren't adjusted periodically, tax burdens will increase regularly simply because of the effects of inflation—\$2,000 in one year is worth less and less in following years. This phenomenon is known as bracket creep. The same process tends to reduce the real value of other important features of the tax system over time as well.

In states that do not take account of the bracket creep problem, the existing tax structure in 2001 is likely to be significantly less progressive than it was when the exemptions, deductions and rate brackets were first set at their current value. The way the

federal personal income tax code deals with this problem is by indexing these features of the tax code for inflation. This means that every year, the personal exemption, standard deduction and rate brackets are increased by the amount of inflation.

Many states have followed the federal lead by indexing various parts of their tax structure for inflation: 19 of the 42 states (including Washington D.C.) with broad-based income taxes have passed legislation to index either exemptions, deductions, or tax brackets for inflation—and 7 states currently index all three of these factors. Indexation helps avoid hidden tax hikes on unsuspecting taxpayers—and ensures that growth in income tax burdens will only take place when lawmakers explicitly decide that it should.

As previously noted in this chapter, lawmakers seeking to increase exemptions and deductions that are *not* indexed for inflation are fighting a losing battle: in this situation, frequent tax cuts are necessary simply to offset inflationary tax increases. Indexation eliminates this political difficulty for lawmakers.

### **Linking to the Federal Income Tax**

Almost all states levying income taxes link the tax to the federal income tax structure, either by making federal income definitions the starting point for state calculations, or by calculating tax as a percentage of federal tax. Like most states, Illinois uses Federal Adjusted Gross Income as a starting point in defining gross Illinois income. Linking the Illinois tax base to the federal income tax base has several important implications for taxpayers and for policy makers:

- The administrative burden on taxpayers and on tax collectors is generally much lower. The complexity of state income tax calculation is usually inversely related to the degree to which the tax is linked to the federal income tax. One can imagine a hypothetical Illinois tax return with just two lines—the federal tax paid by the taxpayer, and the result of a percentage of federal calculation in which Illinoisans pay a flat percentage of their federal tax to the state. Chapter Seven shows that this sort of simplifying change could be made in a way that leaves the aggregate amount of Illinois income taxes unchanged, cuts taxes for 70 percent of Illinoisans, and results in a windfall to Illinois taxpayers of \$360 million due to federal tax cuts for itemizers.

- On the other hand, the simplicity of the federal-based structure can only be preserved if state lawmakers agree to adopt tax reforms enacted by the federal Congress. For example, if Congress enacts a new deduction for long-term health care expenses, Illinois lawmakers must either conform to the federal decision—which means a reduction in the Illinois tax base—or not conform to the federal decision, which means that Illinois taxpayers must take an extra step in calculating Illinois adjusted gross income. In the long run, the more Illinois decides to depart from federal income definitions, the less useful the federal linkage will be.

### **Constitutional Limitations and the Illinois Income Tax**

Like most of the states currently levying flat-rate personal income taxes, Illinois has enshrined its flat-rate tax structure in its constitution, which means that one of the most obviously effective means of making the state income tax more progressive—instituting a graduated rate structure—would require a constitutional amendment.<sup>14</sup> The requirement of a flat-rate income tax is generally understood to mean that the Illinois income tax cannot be made noticeably more progressive than it currently is without constitutional amendment. However, this chapter has argued that existing tax breaks artificially reduce the progressivity of the income tax, and that state policy makers could achieve a more progressive tax system by eliminating these loopholes.

This means that policy makers seeking to increase the fairness of the Illinois personal income tax can achieve this goal without changing the tax rate at all. And even if these tax breaks are not eliminated, policy makers still have other options for adding progressivity to the income tax: graduated rates are only one way of achieving a progressive income tax. A flat-rate, high-exemption income tax can be structured to have the same effect as a graduated-rate tax structure. If we think of the Illinois personal exemption as being equivalent to a zero percent rate on the first \$2,000 of income for single taxpayers, we can see that the use of exemptions and deductions achieves the

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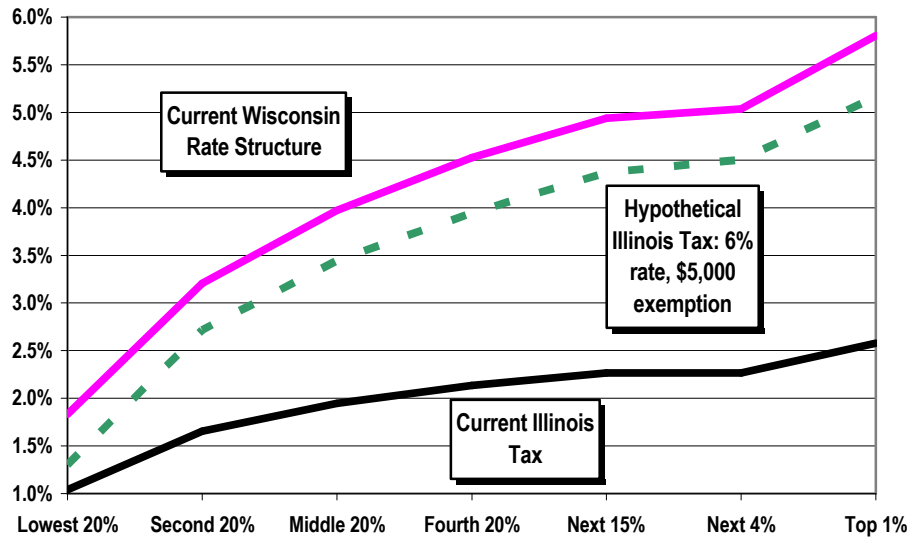
<sup>14</sup>Section 3 of Article 9 of the 1970 Constitution requires that “a tax on or measured by income shall be at a non-graduated rate.”



same effect as a multi-rate structure—taxing lower income levels at lower effective rates.

This means that the constitutional limitations facing Illinois lawmakers do not stand in the way of instituting a more progressive tax system. Wisconsin's income tax, for example, is much more progressive than Illinois's. Yet Illinois could modify its income tax to mirror Wisconsin's progressivity without departing from its flat-rate structure. The chart to the right shows the effective tax burden under the Wisconsin and Illinois income taxes in 2000—and the effective tax burden under a modified Illinois income tax with an increased flat rate of 6 percent and an increased personal exemption of \$5,000. Increasing the flat rate while also increasing the personal exemption would make the incidence of the Illinois income tax quite similar (although slightly lower, in the aggregate) to that of the current Wisconsin graduated rate structure.

**Achieving Progressivity with a Flat Tax:  
Income Tax as a % of Income Under Three Scenarios**



## Interactions Between Illinois Taxes and Federal Income Taxes

A common area of focus in comparing the tax structure of neighboring states is the top marginal tax rate paid on personal income. Arguments have persistently been made by anti-tax activists that high marginal tax rates tend to depress economic growth.<sup>15</sup> However, focusing only on the marginal state income tax rates in each state tends to overestimate the real difference in tax rates between states. The reason that interstate income tax rate differentials are never as large as they appear has to do with the interaction between state and federal income taxes. Because the state personal income tax is deductible from the federal income tax, the real differences between state top marginal rates are even smaller than they appear.

This can be dramatically illustrated by reference to the states surrounding Illinois. The chart on the next page shows the top marginal rate facing tax-

payers in each neighboring state, the effective tax rate on the wealthiest one percent of taxpayers before the federal offset is taken into account, and the same statistic *after* the federal offset.

The top marginal rate on income in Kentucky is 6 percent—3 percent higher than the single Illinois tax rate. But the *effective* top rate after the federal offset is taken into account is about half the nominal top rate in each state. This is because those who itemize on their federal tax returns can deduct state income taxes, the real difference in income tax burden between wealthy taxpayers in Kentucky and Illinois is substantially less than the nominal rates—or even the effective rates before the federal offset—would make it appear.

In other words, paying more state income tax lowers taxpayers' federal income tax, which makes the effective rate of the state tax lower. For a top-bracket federal taxpayer in Kentucky, the 6 percent top state rate is really only about a 3.4 percent rate after accounting for the lower federal tax. The 3 percent rate in Illinois equates to a 1.5 percent effective top marginal rate. So the difference between the top tax rates in Illinois and Kentucky, in terms of their real impact, is actually only 1.8 percentage points—much less than the 3 percentage-point difference one would infer from comparing the nominal tax rates.

<sup>15</sup>*The Case Against a Tennessee Income Tax*, Cato Institute, 1999. For a response, see "High Income Tax States have Strong Economies," on the ITEP website at <http://www.itepnet.org/tncatopr.htm>.

## Effective Income Tax Rates on Top 1% Married Joint Filers, 1995

State	Top Marginal Rate	Effective Tax Rate		Diff from Regional Avg	
		Before Offset	After Offset	Before Offset	After Offset
<b>Illinois</b>	<b>3%</b>	<b>2.5%</b>	<b>1.6%</b>	<b>-1.9%</b>	<b>-1.2%</b>
Iowa	8.98%	5.2%	3.2%	0.8%	0.5%
Indiana	3.4%	3.2%	1.9%	-1.2%	-0.8%
Kentucky	6.0%	5.6%	3.4%	1.1%	0.7%
Michigan	4.2%	4.1%	2.5%	-0.3%	-0.2%
Missouri	6.0%	5.0%	3.1%	0.6%	0.4%
Wisconsin	6.75%	5.4%	3.3%	0.9%	0.6%
<b>Regional Average</b>		<b>4.4%</b>	<b>2.7%</b>		

This smoothing effect of the deductibility of state income taxes on federal tax forms is one of the most important—and least understood—factors determining the real impact of a state income tax on its citizens. Federal deductibility means that the real differences in income tax burdens between high-tax and low-tax states are never really as large as they appear to be. This feature is a good deal for states like Wisconsin and Minnesota that rely heavily on income taxes, because it allows states with progressive income taxes to export part of their tax burden to the federal government. Conversely, the federal offset is an especially *bad* deal for states like Illinois, because the state loses the ability to export a substantial part of its tax burden to the federal government.

### Conclusion

Illinois is less reliant on the personal income tax as a source of revenue than almost all of the 41 states currently collecting broad-based income taxes. The state's income tax is also one of the *highest* income taxes on poorer taxpayers. Each of these seemingly contradictory findings stem from the same underlying structural problems in the state's income tax: the flat-rate structure of the tax, the relatively small amounts of targeted low-income relief delivered by personal exemptions and the Earned Income Tax Credit, and the poor targeting of various other exemptions and credits.

These last-mentioned tax breaks decrease the progressivity of Illinois's income tax so much that while the total Illinois income tax burden is one of the lowest among states currently levying such a

tax, the income tax burden on low-income Illinoisans is relatively high.

In addition to taxing lower-income taxpayers more heavily than most states, the Illinois income tax structure also discriminates between otherwise similar taxpayers based on the source of their income. Tax breaks for pension and Social Security income penalize elderly wage earners by exempting retirement income while fully taxing wages.

By disproportionately balancing the state's income tax on the backs of its poorest citizens, Illinois

hampers its ability to capture the gains from economic growth—and fails to take advantage of the interaction between state and federal taxes. Progressive reform of the income tax would revitalize the state's revenue collections—and would be subsidized by offsetting federal tax cuts. Chapter 7 of this report looks at a series of income tax reform options that would increase the overall progressivity of the income tax while exporting a larger share of the income tax burden to non-Illinois residents.

# ILLINOIS PROPERTY TAXES

Property taxes are the only major revenue source for which the Illinois state and local tax burden exceeds the national average—indicating a fundamental imbalance in the state's tax structure. While various property tax relief measures have been enacted, these tax breaks are unavailable to many low-income Illinoisans—indicating a lack of balance within the property tax base itself. The state's continued reliance on regressive local property taxes as a source of revenue to fund important services—especially elementary and secondary schools—raises important equity issues, since poor school districts are frequently unable to raise sufficient levels of property taxes to provide their desired level of services.

## The Total Illinois Property Tax Burden

While property taxes have declined as a share of taxes nationwide, the share of state and local tax 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 ten other states derived a greater share of their tax revenue from the property tax. Expressed as a percentage of personal income, the Illinois property tax burden is well above the national average, and is growing even as the property tax burden nationwide has declined. In fiscal 1999, state and local property taxes represented 3.8 percent of personal income in Illinois—twenty percent above the 3.2 percent national average. As a result, the state's ranking has increased from 21<sup>st</sup> to 12<sup>th</sup> by this measure over the past two decades. In the past decade alone, Illinois property taxes have grown more than twice as rapidly, on a per capita basis, than property taxes in the nation as a whole—and more quickly than almost all neighboring states.

## Trends in Illinois Property Taxes

	As a % of Personal Income				As % of Total Taxes			
	1979	US Rank	1999	US Rank	1979	US Rank	1999	US Rank
Illinois	3.5%	21	3.8%	12	35.0%	19	37.1%	11
Indiana	2.9%	30	3.4%	19	33.0%	24	33.2%	15
Iowa	3.8%	19	3.5%	15	37.9%	13	33.0%	16
Kentucky	1.8%	48	1.9%	44	17.7%	44	17.1%	44
Michigan	3.9%	18	3.2%	22	35.8%	16	29.5%	23
Missouri	2.5%	37	2.3%	39	28.3%	32	23.6%	37
Wisconsin	4.0%	17	3.9%	11	33.9%	21	31.7%	19
<b>ALL STATES</b>	<b>3.3%</b>		<b>3.2%</b>		<b>31.6%</b>		<b>29.5%</b>	
<b>IL as % of US avg</b>	<b>106%</b>		<b>120%</b>		<b>111%</b>		<b>126%</b>	

Source: Bureau of Economic Analysis, Bureau of the Census

## The Distributional Impact of Illinois Property Taxes

Illinois property taxes are regressive: lower-income taxpayers generally pay more, as a share of income, than do better-off taxpayers. The 20 percent of Illinois taxpayers making less than \$15,000 pay 4.3 percent of their incomes in property taxes. The middle 20 percent of Illinoisans, with average income of \$36,400, pay

## Average Annual Growth in Per Capita Property Taxes: 1989-1999

	Growth Rate	US Rank
Illinois	3.3%	11
Indiana	4.4%	2
Iowa	-0.5%	44
Kentucky	3.3%	10
Michigan	-1.8%	48
Missouri	3.2%	15
Wisconsin	1.4%	31
<b>ALL STATES</b>	<b>1.5%</b>	

Source: Bureau of the Census

2.7 percent of their incomes in property taxes. The wealthiest one percent of Illinois residents, with average incomes of \$1.2 million, pay 2.2 percent of their incomes in property taxes.

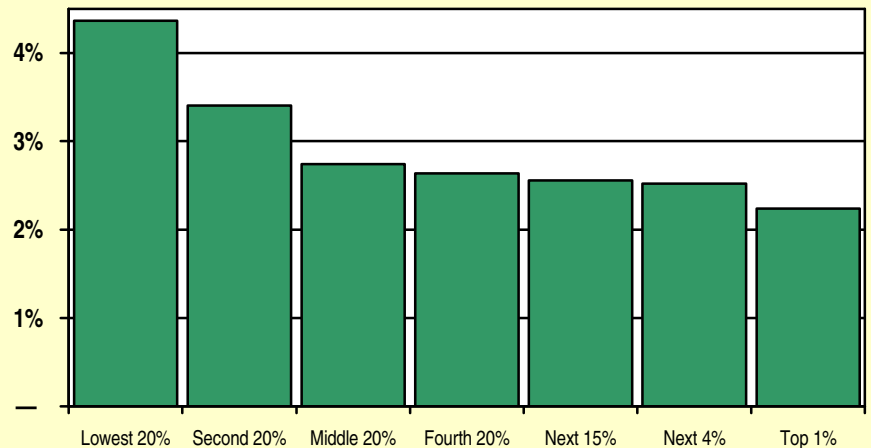
The chief reason that property taxes are regressive is that they are based on home values rather than on income levels—and home values do not vary directly with income levels. Home values represent a much higher share of income for middle- and lower-income families than for the wealthy. For example, it is common for a middle-income family to own a home valued at two or three times their annual income, but wealthier taxpayers are less likely to own homes worth as much relative to their income levels. As a result, property taxes generally take a larger share of income from middle-income families than from the better-off. Far from representing a taxpayer's ability to pay, property taxes tend to be highest for those with the least ability to pay. And property taxes are insensitive to variations in taxpayers' income: a taxpayer who suddenly becomes unemployed will find that his property tax bill is unchanged, even though his ability to pay it has drastically fallen. (By contrast, income tax bills depend on the level of earned income, so income taxes are much more sensitive to taxpayers' abilities to pay—an important issue as state unemployment increases.)

While the public's attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home.

Renters are generally assumed to pay some of the property taxes falling on owners of rental real estate indirectly, in the form of higher rents. This is an important consideration, because most of the property tax relief dollars spent in Illinois are currently targeted to homeowners. Because renters tend to be poorer than homeowners, the omission of renters from the state's major property tax relief programs (including the homestead exemption and the five percent property tax credit) increases the property tax burden on those least able to afford it—the very poorest Illinoisans.

Property taxes are also levied on businesses. A good portion of the business property tax is exported to out-of-state shareholders and owners. This is an important consideration, because without

**2000 Illinois Property Taxes as Shares of Family Income**  
(Includes both individual and business taxes)



the business property tax, many businesses that utilize Illinois government services would go largely untaxed.

As is the case with the personal income tax, a portion of Illinois property taxes on individuals is offset by federal income tax deductions—resulting in a tax discount of close to \$1 billion compared to a non-deductible tax.

## Defining the Tax Base

Property taxes are generally divided into two categories: *real* property, which includes land, buildings and improvements, and *personal* property, which includes all other property. While real property taxes are used widely in all fifty states, many states have lessened their reliance on personal property taxation. Illinois is one of only ten states nationwide that have completely eliminated personal property from the tax base. Since personal property items such as motor vehicles are typically the largest personal property asset in a household's portfolio (and are generally the second-largest asset of any kind, after homes), the trend toward exempting personal property has curbed the growth of property tax revenues nationwide. Yet the exclusion of personal property from the Illinois tax base appears primarily to have encouraged higher taxation of the remaining taxable property.

The Illinois property tax is reduced by three types of exemptions. First, a large amount of property is simply not counted as part of a taxing district's assessed value because of the nature of its ownership. Property owned by federal, state and

local governments, religious organizations, and education or charitable groups is all exempt from taxation.

Second, an equally large amount of property is excluded from assessed value because of the nature of the property itself. Tangible and intangible (items such as stocks, bonds, and invested property more generally) personal property are both completely exempt from tax.

A third broad category of property is included in assessed value, but then exempted based on factors such as household income (in the case of the homestead exemption) or corporate investment behavior (in the case of manufacturing tax abatements).

### Property Taxes and Local Responsibilities

Like most states, Illinois raises the vast majority of its property taxes at the local level. More than 98 percent of Illinois property tax revenues were raised at the local level in fiscal 1997. Since local property tax revenues are designated overwhelmingly for funding elementary and secondary education in each district, the state’s reliance on local property taxes creates inequities between available funding for property-wealthy and property-poor districts. In recent years, lawmakers have sought to reduce the funding disparities between districts by increasing the “foundation level” of total district per-pupil spending. This move has helped to ensure that more property-poor districts can provide levels of spending that approach the statewide average. However, the basic inequities between school districts receiving the foundation level of per-pupil funding and wealthier districts that can independently supply a much greater per-pupil amount remain.

### Property Tax Relief Mechanisms

Illinois provides several state-funded property tax relief mechanisms, including exemptions and credits. Most of these mechanisms are targeted exclusively toward homeowners and businesses.

#### Property Tax Exemptions

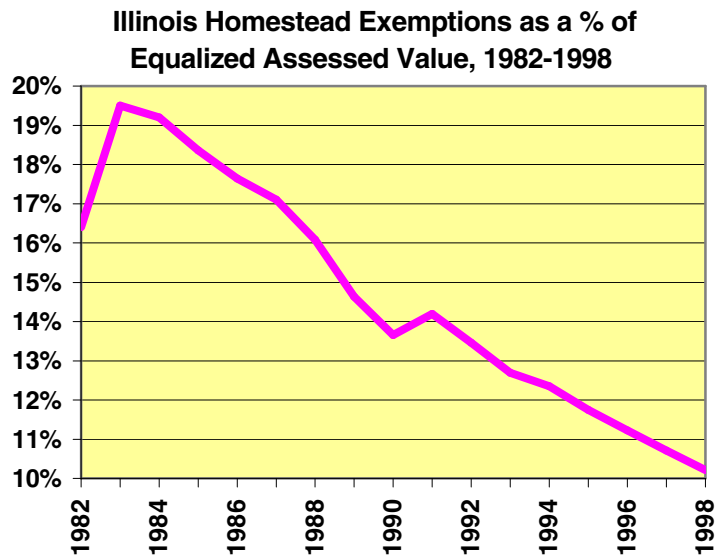
The most frequently used form of state property tax relief for homeowners is the *Homestead Exemption*, which usually exempts a flat dollar amount, or a flat percentage of home value, from property tax. The Illinois homestead exemption, enacted in 1978,

is relatively unusual in that it is calculated by reference to the *change* in home value since 1977. The amount of homestead exemption available to a homeowner in tax year 2000 is the increase in assessed value of the property for the current tax year over its assessed value in 1977. The value of the homestead exemption is capped at \$3,500 (\$4,500 in Cook County).

Because the Illinois maximum homestead exemption is a fixed dollar amount, the exemption is mildly progressive in its impact on homeowners: Cook County’s \$4,500 exemption represents a larger share of a property’s value for less expensive homes. Yet because the exemption is limited to owner-occupied homes, the homestead exemption is completely ineffective in offsetting property taxes paid by renters.

The Illinois homestead exemption has also diminished in value since it was first enacted. The regular \$3,500 maximum homestead exemption has not been increased since 1978. As a result, the exemption is worth much less today than in 1978: if the \$3,500 maximum had been indexed for inflation, it would be \$9,200 today. The rapid growth of property values during this period means that the homestead exemption becomes less effective as a property tax relief tool every year. The dollar value of homestead exemptions granted in 1998 was just over 10 percent of the equalized assessed value of residential property—down from 19 percent in 1983.

In addition to the homestead exemption, Illinois also allows an exemption for the value of additions to a residential property. The *Homestead Improve-*





ment Exemption is limited to \$45,000 of added home value, and is limited to the first four years after the improvement is complete and occupied.

Enacted in 1971, the *Senior Citizens Homestead Exemption* exempts from tax \$2,000 of the equalized assessed value of real property. Like the regular homestead exemption, the Senior Citizens exemption is restricted to owners of residential property who are liable for real estate taxes on the property. This exemption is given in addition to the homestead exemption. Like the regular homestead exemption, the Senior Citizen exemption has declined in real value over time. It also offers no tax relief for senior citizens who rent their homes.

The *Senior Citizens Assessment Freeze Homestead Exemption* was designed to allow elderly homeowners to avoid increases in the assessment on their homes. Taxpayers with household income of \$40,000 or less can elect to maintain the equalized assessed value of their homes at the base year values.

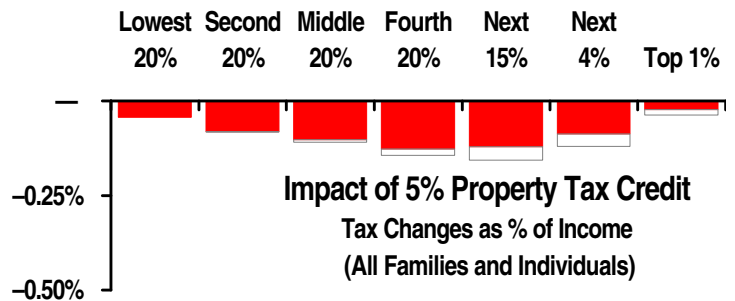
Finally, the *Disabled Veterans' Exemption* allows disabled veterans to exempt up to \$58,000 of their home's assessed value.

### Property Tax Credits

The most important property tax relief mechanism available to Illinois homeowners is the property tax credit against state income taxes. Illinois homeowners may claim an income tax credit of 5 percent of property taxes paid. Because the credit is claimed on state income tax forms, it functions as a *refund* through which property taxes already paid are rebated to income-tax payers—an odd approach to property tax relief, since it depends on *income* tax liability. The progressivity of the credit is limited by several important features:

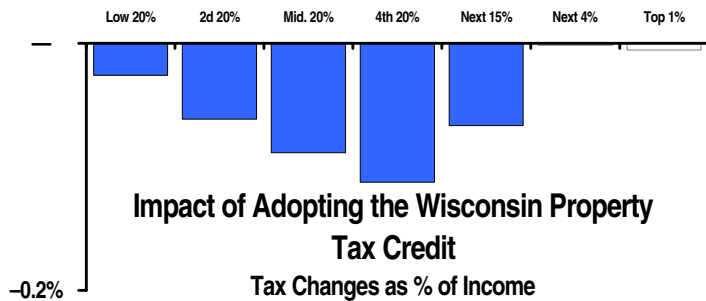
- Because the credit is limited to Illinois homeowners who paid property taxes on their primary residence, it is not available to taxpayers who rent their homes—even though it is generally accepted that a substantial portion of property taxes on rental properties are passed through to renters.

- While the maximum credit is calculated as 5 percent of property tax liability, the amount of the credit which can be claimed is limited to the total amount of personal income taxes paid. This means that low-income taxpayers with relatively high property tax burdens may not be able to use the full amount of this credit. And elderly taxpayers, whose income tends to be concentrated in non-taxable pension and Social Security income, may be entirely ineligible for the credit.
- Because the credit is calculated as a percentage of property taxes rather than set at a fixed dollar amount, taxpayers with more expensive homes get more property tax relief than those with less expensive homes.



There is no limit on the income level at which taxpayers may take advantage of this credit. By contrast, the Wisconsin credit for property taxes paid is capped at \$300 per household. The Wisconsin approach reduces the cost of the credit and targets its benefits more effectively to low-income taxpayers. Even though the Wisconsin credit is calculated as 12 percent of property taxes (compared to 5 percent for the Illinois credit), the state of Illinois would save \$175 million by adopting the Wisconsin credit—and the modified credit would provide a larger tax cut, on average, to the poorest 95 percent of Illinois taxpayers. The following chart shows the net impact of Illinois replacing its 5 percent property tax credit with the Wisconsin credit in 2000.





An additional effect of the existing property tax credit that receives relatively little attention is how it increases the federal income taxes paid by Illinoisans claiming the credit. Almost 20 percent of the Illinois income tax cut from this credit is directly offset by increased federal income tax payments. This means that less than 80 percent of the state revenue loss from this credit finds its way into the pockets of Illinois residents. One way to reduce this leakage would be to phase out the property tax credit above a certain income level. Chapter Seven shows the impact of limiting the property tax credit to the first \$300 of tax liability—as was done with the one-time property tax rebate issued in 1999. Such a change would increase state income tax collections by \$38 million in 2000—and would *reduce* federal taxes paid by Illinoisans by more than \$10 million.

The other major form of property tax relief targeted at Illinois senior citizens is the state's *Elderly Circuit Breaker* program. The program is called a circuit breaker because it is targeted only to taxpayers whose property tax burden exceeds their ability to pay them. The Illinois circuit breaker is targeted to lower-income elderly homeowners and renters. In 2000, the state disbursed \$51 million in direct relief to 200,000 individuals through this program, for an average credit of \$256 per recipient. The amount of this credit available to homeowners is limited by four factors: the age of the taxpayer, the amount of property taxes paid, household income, and a dollar limitation. Only taxpayers over 65 are eligible, and the maximum credit available is \$700 minus 4½ percent of household income, with a flat \$70 maximum for eligible taxpayers with income over \$14,000. The maximum income for eligibility was \$14,000 from 1972, when the circuit breaker was first enacted, through 1997. In 1998, the income threshold was raised to \$16,000. Legislation enacted in 2000 increased the basic income threshold to \$21,218 for households

containing one person, and provided higher thresholds for larger households: effective calendar year 2001, the income eligibility threshold for a two-person household is \$28,480, and the threshold for a three-person household is \$35,740.

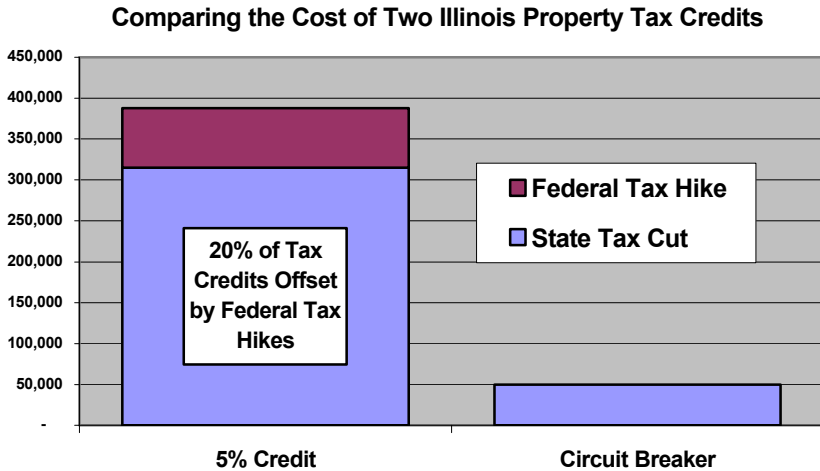
The 1998 legislation expanding the thresholds made more elderly taxpayers eligible for this tax credit. Yet this legislation was insufficient to offset the real decline in the credit's value since its creation in 1972.

- If the maximum income level for eligibility had been indexed for inflation since the circuit breaker was introduced, the maximum income level in 2000 would have been \$57,000—more than double the current threshold for two-person families claiming the credit, and almost three times higher than the current threshold for single elderly taxpayers.
- A more serious problem is that the legislation enacted since 1998 does nothing to counteract the decreasing value of the credit for the low-income Illinoisans who need it most. The maximum value of the credit has been capped at \$700 since its introduction—and the real value of this \$700 credit has declined substantially since 1972. If the maximum value of the credit had been indexed during this period, it would be \$2,884 in 2000—more than four times its current value.
- The credit's value has declined even more for renters than for homeowners. This is because the percentage of rent used in calculating renter property taxes was lowered from 30 percent to 25 percent in 1992.

In other words, the net impact of legislation expanding circuit breaker eligibility has not been enough to offset the effects of inflation in *reducing* the real value of the eligibility thresholds. And lawmakers have taken no steps at all to mitigate the impact of inflation on taxpayers earning under \$14,000—arguably the population most in need of the tax relief the circuit breaker is designed to provide.

The inattention of lawmakers to preserving the value of the circuit breaker is especially noteworthy because even at its recently expanded level, the elderly circuit breaker costs significantly less than

the annual 5 percent property tax credit. As the next chart shows, the 5 percent property tax credit reduces state income taxes by \$390 million in tax year 2000, compared to \$50 million for the circuit breaker. The federal tax *hike* due to the 5 percent credit is actually greater than the entire state tax cut due to the circuit breaker. In other words, the current revenue loss to Illinois state taxpayers due to the 5 percent credit's federal offset could fund a doubling of the Illinois circuit breaker's current cost.



### 1999 Property Tax Rebate

Legislation passed in July of 2000<sup>16</sup> created a one-time property tax rebate, targeted to Illinois homeowners with positive income tax liability. The rebate was tied to the amount of tax credit claimed by Illinois taxpayers in 1999 for property taxes paid. The linkage to the income tax credit meant that the rebate inherited several important characteristics of the credit:

- The rebate was not limited at higher income levels. Taxpayers at all income levels could claim the maximum amount of the credit.
- The rebate was limited to homeowners. Because the income-tax-based property tax credit is not available to Illinois taxpayers who rent their residences, the rebate was unavailable to these taxpayers as well.
- The rebate was limited to taxpayers with positive income tax liability. Since the property tax credit is nonrefundable, taxpayers with zero income tax liability before credits cannot claim it—and taxpayers with very

low levels of income tax liability cannot claim the full amount. Since the rebate was tied to the amount of property tax credit claimed, any limitation on the amount of credit claimed by low-income taxpayers was passed on to the property tax rebate.

- While the rebate was not considered to be taxable income for Illinois state tax purposes, the rebate amounts were fully taxable on the 2000 federal tax forms for all Illinois residents who claimed their Illinois property tax liability as an itemized deduction.

However, the property tax rebate differed from the property tax credit in one important way: the amount of the rebate was capped at \$300. This increased the progressivity of the rebate somewhat, while minimizing its cost.

Although the rebate was roughly proportional—giving almost identical cuts as a percentage of income across most of the income distribution—the taxability of the rebate on federal itemizers' returns means that a substantial percentage—more than 15 percent—of the state tax reduction enjoyed by Illinois taxpayers was offset by a federal income tax increase. For the very highest-income taxpayers, close to 40 percent of the state tax cut went straight to the federal government rather than to Illinoisans. This is an inherent feature of rebate proposals that target their benefits to all taxpayers—the percentage of a state income or property tax cut that actually goes to a state's residents will decline as the percentage of the cut going to high-income taxpayers increases. The greater the percentage going to low-income taxpayers, the greater the percentage that will remain in the state rather than adding to the federal tax coffers.

Any government spending program that simply threw away fifteen percent of its allotted spending totals would be sharply criticized as government waste—yet relatively little attention has been paid to the inefficiency of Illinois policymakers' efforts at property tax relief. More precisely tailoring such property tax credits in the future would reduce the overall cost of these tax rebates and would ensure that a greater percentage of the tax cuts are actually retained by Illinoisans rather than passed on to taxpayers nationwide.

<sup>16</sup>House Bill 3876, Public Act 91-703.

## Property Tax Limitations

Since the passage of California's Proposition 13 in 1978, legislators and voters in many states have enacted limits on the growth of property tax revenues. These limitations tend to place artificial and sometimes arbitrary limits on the ability of local governments to provide the services demanded by their constituents. Illinois limits property taxes paid, through the Property Tax Extension Limitation Law of 1991 (PTELL). The approach taken by Illinois is relatively unusual, however, in that it limits the *aggregate* amount of property taxes collected in a particular district, and in that most districts are allowed to choose whether the PTELL limits should apply.

The PTELL limits were created as a response to high property tax growth in the late 1980s. The PTELL limits were designed to act as a backstop to increasingly ineffective property tax *rate* limits that were already in effect at the time: much of the increase in property tax burdens in Illinois during this period had been due not to rate increases but to increases in assessed value. The PTELL law limits the annual growth of property tax extensions to 5 percent or the previous year's increase in the Consumer Price Index (CPI), whichever is less. Since the program was created, the CPI change has been substantially lower than the 5 percent limit in each year except for 1991. In 1999, this meant that property tax extensions in counties with the PTELL limit could grow by just 1.6 percent over the previous year's level. The main problem with these limits is that the 5 percent limit is arbitrary—and the CPI limit flies in the face of many states' experiences with growth in educational costs. Since many educational costs need to grow faster than inflation—teacher salaries, for example, need to keep up with overall wages—the PTELL limits can force districts to pare back necessary education expenses to meet the limits.

The legislation creating PTELL mandates its use in Cook County and in the “collar counties”<sup>17</sup> surrounding Chicago, but allows all “downstate” counties to decide whether to impose PTELL limitations. Since 1991, more than two dozen downstate counties have enacted the PTELL limitations.

## Personal Property Tax

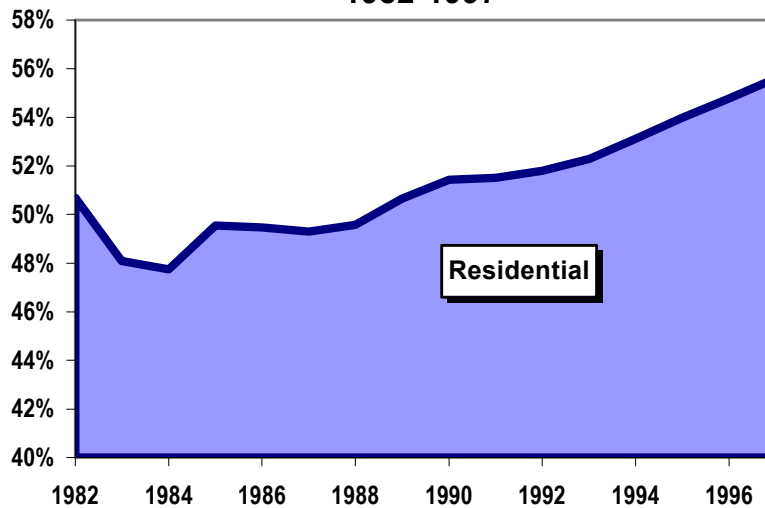
Illinois is one of only ten states to exempt all personal property from taxation. Illinois abandoned taxation of individual personal property in 1970 and exempted business personal property in 1979.

One disadvantage of completely exempting personal property from taxation, while taxing real property, is that tax administrators must distinguish between personal and real property—giving real property owners an incentive to try to characterize items as personal property that are better treated as real property.

Another frequently overlooked disadvantage of exempting personal property is that personal property taxes on individuals can be deducted by federal itemizers in computing their federal taxable income. This means that up to 31 percent of the personal property tax burden can be exported to the federal government. Therefore, the exemption of personal property may diminish the state's ability to export its tax burden.

The exemption of personal property also makes it more difficult to mitigate over-reliance on taxation of residential real property. One of the most striking Illinois property tax trends over the past fifteen years is the movement toward greater reliance on residential property taxes as a source of property tax revenue—and a simultaneous movement away from business and agricultural property taxes. As recently as 1984, business and agricultural property taxes constituted 52 percent of property

**Sources of Illinois Property Tax Revenue  
1982-1997**



<sup>17</sup>Dupage, Kane, Lake, McHenry, and Will Counties.

tax extensions in Illinois—but by 1997 that percentage had declined to just 44 percent. Residential property taxes in Illinois represent a substantially greater share of total property tax extensions in 1997 than 15 years earlier. To some extent, this probably represents an increase in the share of new construction that is residential in nature—but this trend also reflects the inability of local governments to tax personal property.

## Conclusion

Illinois property taxes are among the highest in the nation. And at a time when property taxes have declined as a revenue source for state and local governments nationwide, Illinois has maintained its over-reliance on this regressive source of tax revenue. The result of this revenue imbalance is predictable: the state's tax system hits low-income taxpayers more heavily than in neighboring states with a more balanced tax system, and the use of local property tax revenues for school funding causes fundamental problems of equity between wealthy and poor school districts.

Moreover, the existing tax credits and exemptions designed to offer property tax relief are poorly targeted. Non-elderly taxpayers—and taxpayers who rent rather than own their homes

receive relatively little property tax relief. The property tax relief mechanisms that are most important for low-income Illinoisans—the elderly circuit breaker and the homestead exemption—have lost much of their value since they were introduced, even as lawmakers have extended the benefits of property tax relief to wealthier taxpayers.

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.

Property tax relief has been one of the most frequently discussed tax reform topics in Illinois for more than a decade. The difficulty of achieving property tax reform is largely a product of the close linkage between property taxes and school funding: elementary and secondary education in Illinois has historically been funded primarily through property tax revenues, which means that any reduction in property taxes potentially places K-12 education funding in jeopardy—while raising the specter of loss of local control of funding of schools. Yet the future adequacy of Illinois education may depend on the willingness of state policy makers to rectify the state's revenue imbalance.

# ILLINOIS CONSUMPTION TAXES

Consumption taxes are the second-most widely used source of tax revenue—and the most regressive major revenue source—in Illinois. General sales taxes and specialized excise taxes represented just under a third of all Illinois state and local tax revenues in 1999. Yet the ability of these taxes to support future needs seems likely to decline in future years unless base-broadening reforms are enacted: the Illinois sales tax base, one of the narrowest in the nation, exempts most sales of personal, professional and business services—the fastest-growing areas of personal consumption—and the state's narrow base and high tax rate result in an inequitable tax. And despite a series of regressive excise tax increases in recent years, the yield of the state's excise taxes is likely to decline further unless policy makers continue to raise the rates on these taxes.

## The Total Illinois Consumption Tax Burden

The Illinois sales and excise tax burden is lower than the national average. In fiscal year 1999, Illinois sales and excise taxes amounted to 3.3 percent of personal income—ranking 36th nationally, and just 87 percent of the national average. The Illinois consumption tax burden is also lower than that of all neighboring states by this measure. Moreover, the state's consumption tax burden has decreased since 1979 relative to the national average—and relative to other Midwestern states.

However, the state's reliance on one category of consumption tax—selective sales and excise taxes on particular items—is actually somewhat *higher* than the national average. While the state's general sales tax burden is 31 percent below the national average, the Illinois excise tax burden is 17 percent higher than the U.S. average.

As a result, Illinois derives an unusually high percentage of its consumption tax revenues—43 percent in fiscal 1999, well above the national average of 31 percent—from excise taxes on particular items such as cigarettes, gasoline and

## Trends in Illinois Consumption Taxes

	As a % of Personal Income				As % of Total Taxes			
	1978	US Rank	1999	US Rank	1978	US Rank	1999	US Rank
Illinois	3.9%	25	3.3%	36	38.4%	24	32.6%	29
Indiana	3.8%	28	3.1%	39	40.9%	20	30.5%	35
Iowa	2.7%	45	3.5%	33	26.7%	43	33.4%	28
Kentucky	4.2%	21	4.0%	22	41.6%	19	36.6%	22
Michigan	3.0%	42	3.4%	34	27.4%	42	31.3%	33
Missouri	3.8%	27	4.0%	21	42.6%	18	39.9%	19
Wisconsin	3.2%	39	3.6%	29	25.9%	44	0	37
<b>ALL STATES</b>	<b>3.9%</b>		<b>3.8%</b>		<b>34.9%</b>		<b>35.7%</b>	
<b>IL/ US avg</b>	<b>101%</b>		<b>87%</b>		<b>110%</b>		<b>91%</b>	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

alcoholic beverages, and a relatively small percentage of its consumption tax revenue from its state and local general sales taxes. This imbalance is largely a product of the narrowness of the state sales tax base—and the state's willingness to frequently increase excise taxes.<sup>18</sup>

## The Most Regressive Tax

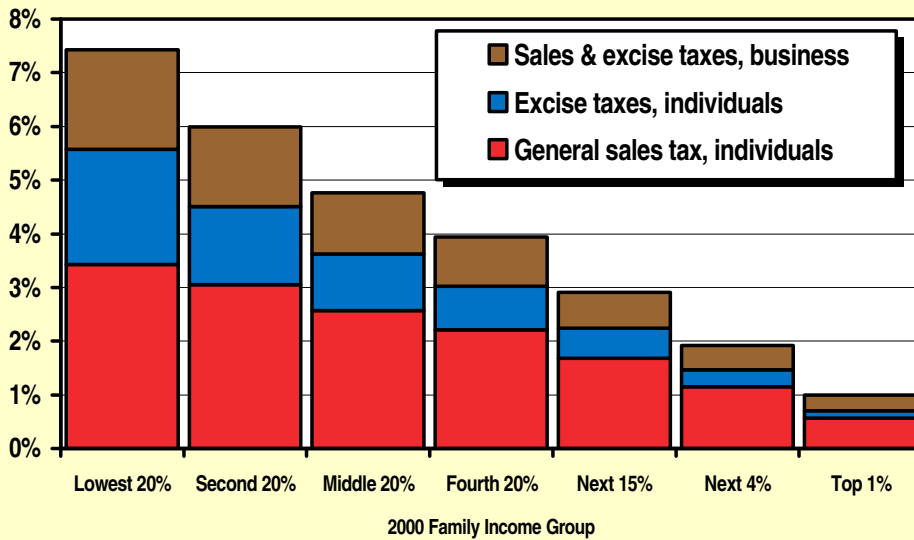
Consumption taxes are inherently regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. Typically, low-income families spend three-quarters of their income on items subject to sales tax, middle-income families spend about half their income on items subject to the sales tax, and the wealthiest taxpayers spend less than a sixth of their income on such items. The distributional impact of Illinois consumption taxes reflects this pattern:

- The poorest twenty percent of Illinoisans—those earning less than \$15,000—paid 7.4 percent of their income in consumption taxes in 2000.

<sup>18</sup>Many states include utility gross receipts in the sales tax base rather than taxing these receipts separately. For this reason, it is most meaningful to use the collective burden of sales and excise taxes as the basis for comparisons between states.



### Illinois Consumption Taxes As Shares of 2000 Family Income



- Illinoisans in the middle of the income distribution paid an average of 4.8 percent of their income in consumption taxes.
- The wealthiest one percent of taxpayers paid an effective consumption tax rate of 1.0 percent in 2000.

This means that low-income Illinoisans pay more than seven times the effective sales and excise tax rate that the wealthy pay. Put another way, the Illinois consumption tax structure is equivalent to an income tax with a 7.4 percent rate for the poor, a 4.8 percent rate for the middle class, and a 1 percent rate for the wealthiest Illinois taxpayers. Obviously, no one would intentionally design an income tax that looks like this—yet by relying on consumption taxes as a revenue source, this is effectively the choice Illinois policy makers have made. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in an innocuous looking single rate and that the amount families pay is hidden in many small purchases throughout the year.

### A High-Rate Tax

The Illinois general sales tax was introduced in 1933, with a tax rate of 2 percent, as a response to Depression-induced revenue shortfalls. The statewide rate in 2001 is 6.25 percent, with a special reduced rate of 1 percent on groceries, prescription and nonprescription medicines, drugs, and various medical supplies and equipment. The Illinois sales tax rate is quite high relative to most

other states: the statewide rate of 6.25 percent is the sixth-highest among the 45 states currently levying state sales taxes, and second only to Minnesota among neighboring states.

Illinois localities were first allowed to levy general sales taxes in 1955. By the late 1980s, local taxing authority had been granted so widely that a confusing array of local tax rates and tax bases had sprung up. In addition to the 5 percent state rate, most localities were levying and collecting an additional 1.25 percent in local taxes, with additional taxes in many home rule districts. The variety of tax rates—and tax

bases—was an administrative nightmare for taxpayers and tax collectors. Legislation enacted in 1988 simplified and centralized the tax collection procedure. In 1990, the state began collecting not just the 5 percent state tax rate, but also two county sales taxes (a 1 percent tax and a 0.25 percent tax), and also administered the home rule taxes that were levied at the time. In addition to centralizing tax collections, the 1990 reforms also required a uniform tax base for each type of local sales tax.

Since the reforms were implemented in 1990, the uniformity of the tax base has made the sales tax administratively easier to pay and collect. Yet the variety of local option sales taxes available to localities has meant that the sales tax burden on low- and middle-income Illinoisans has grown steadily higher. A series of enabling laws has allowed localities to enact these taxes for various purposes:

- **Home rule districts** are allowed to levy sales taxes in 0.25 percent increments. When the state took over the duty of collecting these taxes, in September of 1990, 22 districts were levying the tax. Perhaps in response to the new administrative ease of collecting the tax, many localities have adopted these taxes in the past decade. As of January, 2002, more than 100 home rule districts had enacted sales taxes ranging from 0.25 percent to 1.25 percent. The \$389 million in home rule taxes collected in fiscal year 2000

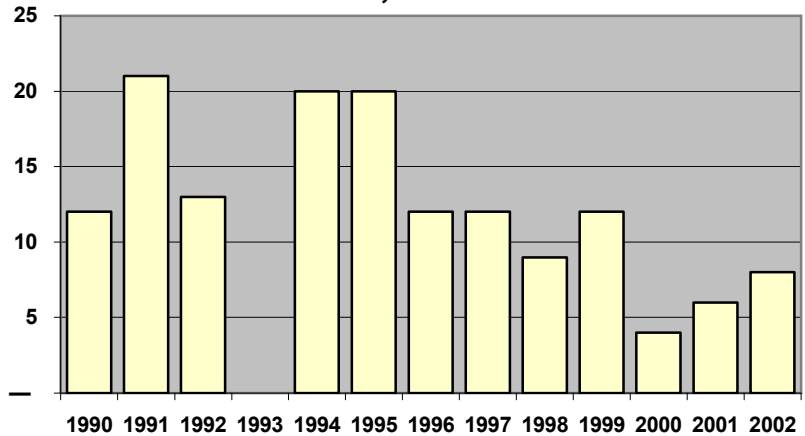


represented a tax hike of \$260 million over the sales taxes that would have been collected if no home rule tax hikes had taken place in the 1990s.

- As a result of 1999 legislation, **non-home rule districts** are allowed to levy sales taxes starting in January of 2002. Nine districts started collecting these sales taxes in 2002, with rates ranging from 0.5 percent to 1 percent.
- Legislation enacted in 1995 allowed counties with populations over 180,000 to enact (subject to a voter referendum) a **public safety sales tax**, in 0.25 percent increments. 1997 legislation allowed counties of any size to enact the tax. In January of 2002, Kendall and Perry Counties became the 16<sup>th</sup> and 17<sup>th</sup> counties to levy this tax.
- The state also allows regional sales taxes for counties located in “mass transit districts.” The **Regional Transportation Authority (RTA) tax** is levied in Cook County and the five “collar counties,” with a 0.25 percent rate in the collar counties and a 0.75 percent rate (1 percent on food and drugs) in Cook County. The **Metro-East Mass Transit District (MED) tax** is levied in Madison County at a 0.25 percent rate and in St. Clair County at a 0.75 percent rate.<sup>19</sup> A **County Water Commission Tax** of 0.25 percent is levied in DuPage, Cook and Will Counties.
- The tax base for the home rule, non-home rule, and public safety sales taxes cannot include food, drugs or vehicle sales. The tax base for the RTA and MED taxes does include food and drugs.

As a result of this network of local sales tax rates, the sales tax in most counties exceeds the statewide rate of 6.25 percent. For example, the total sales tax on most transactions in the city of Chicago is 8.75 percent. A recent study by the District of Columbia Department of Revenue<sup>20</sup> compared the total sales tax burden in the largest cities of all fifty states and found that Chicago’s sales tax burden ranked second highest in the nation: only

## Districts Increasing Home Rule Taxes, 1990-2002



the 9 percent combined sales tax rate in New Orleans exceeded the rate levied in Chicago.

### A Narrow Base

If the Illinois sales tax *rate* is high compared to most other states, how can the overall sales tax *burden* be lower than the national average? The answer lies in the definition of the Illinois sales tax *base*.

The Illinois general sales tax actually has two components: the retailers’ occupation tax, which generally taxes sales of tangible personal property, and the service occupation tax, which generally taxes sales of property used in performing nontaxable services. The sales tax base defined by these two taxes is quite narrow compared to that of most other states. One recent analysis found that the Illinois sales tax base in fiscal 1998 was narrower than all but three other states.<sup>21</sup> The narrowness of the Illinois sales tax base is due to two types of exemptions: exemptions of *tangible property*—the basic building block of all sales taxes historically—and exemptions of *services*, which have never been effectively taxed by most states.

Many states have tried to compensate for the regressivity of general sales taxes by exempting

<sup>19</sup>No other district is allowed to levy the MED tax except, Monroe County, which does not currently do so.

<sup>20</sup>*Tax Rates and Tax Burdens In The District of Columbia, A Nationwide Comparison 1999*. Chief Financial Officer, June 2000.

<sup>21</sup>John Mikesell, “Remote Vendors and American Sales and Use Taxation,” *National Tax Journal* 53/4, p. 1273 (2000). Mikesell estimates the implicit Illinois sales tax base to be about 31.8% of personal income, substantially below the national average of 49.5 percent, and lower than all other states except Rhode Island, New Jersey, and Massachusetts.

## High Rate, Low Yield: The Illinois Sales Tax

State	State GST Rate	Regional Rank	State GST Revenue as % of Income	Regional Rank
Illinois	6.25%	2	1.6%	7
Indiana	5%	4	2.2%	5
Iowa	5%	4	2.3%	4
Michigan	6%	3	2.6%	1
Minnesota	6.50%	1	2.4%	2
Missouri	4.225%	7	1.9%	6
Wisconsin	5%	4	2.3%	3

SOURCE: Bureau of the Census, Bureau of Economic Analysis

certain retail sales of tangible property that can be considered essentials. The most popular such exemption is for sales of prescription drugs, which are fully exempted by every state with general sales taxes except Illinois. Another increasingly popular exemption is for groceries. Twenty-seven states now exempt sales of groceries from the state sales tax.<sup>22</sup> Six states exempt sales of non-prescription drugs and six states (all in the Northeast) exempt sales of most items of clothing. Illinois takes a relatively unusual approach: instead of completely exempting necessities, the state applies a special lower tax rate to sales of groceries, prescription drugs, and nonprescription drugs. These items are taxed at a 1 percent rate, substantially less than the 6.25 percent general rate.

While these reduced rates lessen the regressivity of the sales tax, they have two important shortcomings:

- **Poor targeting.** Much of the tax relief generated by these reduced rates goes to better-off households for whom the sales tax burden is already relatively low. Less than 9 percent of the tax relief from the state's reduced rate for groceries goes to the poorest twenty percent of Illinois taxpayers. This means that the vast majority of the tax savings from the food exemption go to better-off taxpayers. And the reduced rates also apply to

<sup>22</sup>Georgia phased out its food tax between 1996 and 1998; North Carolina phased out its tax between 1997 and 1999; Missouri lowered its food tax from 4.225% to 1.225% in 1997; Virginia recently began a series of rate reductions, beginning in January of 2000, that will lower the state sales tax on food from 3.5% to 1.5% by 2003. South Carolina adopted a temporary cut in its sales tax rate, which has since expired.

residents of any state consuming these items in Illinois—so the tax breaks from the exemption are not limited to Illinois residents.

- **Cost.** Because the benefits from the reduced rates are so poorly targeted, these tax breaks are quite expensive. The reduced rates for food, drugs and medical appliances have been estimated to cost over \$1 billion in fiscal year 2000—almost 16 percent of total state sales tax collections. This means that each penny of the state sales tax yields about 16 percent less revenue than it would in the absence of these exemptions. Some economists have argued, in fact, that states exempting important items such as groceries are likely to respond to the revenue loss by increasing sales tax rates.<sup>23</sup> If states do, in fact, respond to exemptions this way, the goal of providing low-income tax relief may be frustrated.

All state sales taxes also include provisions for exempting sales of tangible property purchased by businesses as inputs into the production process. Despite the widespread use of these provisions, there is evidence that business purchases remain a substantial part of the sales tax base in most states.<sup>24</sup> This is because the general approach taken by states has been to exempt only business purchases of tangible property that physically becomes part of a final retail product. But sales taxes on other businesses purchases also end up in the price of retail goods and services, leading to tax pyramiding, that is, multiple taxation of the same final products. Pyramiding results in unfair differences between the tax treatment of otherwise identical products depending on how vertically integrated a business may be. For this reason, economists generally agree that it is theoretically desirable to exempt business purchases used in production—including purchases of business services.

<sup>23</sup>Roy Bahl and Richard R. Hawkins, "Does a Food Exemption Lead to a Higher State Sales Tax Rate?" *State Tax Notes*, January 5, 1998, p.29. See also Calvin Kent *et al.*, "The Impact on the Economically Disadvantaged of the Sales Tax on Food: Evidence from West Virginia," *States Tax Notes*, Nov. 9, 1998, p.1201.

<sup>24</sup>Raymond J. Ring, Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," 42 *National Tax Journal* 167 (1999).

The Illinois exemptions for essentials and business inputs were explicitly written into the tax code by legislators. Yet the most important class of sales tax exemptions allowed in Illinois can't be found on the books at all. While the Illinois sales tax base applies to sales of tangible property unless exempted, sales of intangible services are exempt unless explicitly taxed. This is due to an accident of history: throughout the first half of the twentieth century, economic activity in the United States was focused primarily on the production and consumption of tangible goods, and the production of services was much less important as a share of GNP. However, since 1950, the importance of services has almost continuously increased as a share of the economy, and the goods-producing sectors of the American economy have declined by roughly the same percentage: in the mid-1970s, service-producing sectors first accounted for more than half of private GNP. In 1997, the share of U.S. current-dollar Gross State Product accounted for by private services-producing industries was 63.9 percent.<sup>25</sup> Industries such as agriculture, manufacturing, mining, and construction have become less important during the last fifty years, and have been replaced by services, retail and wholesale trade, finance, insurance and transportation. Individual consumption patterns have changed accordingly.

Unfortunately, most state sales taxes were

adopted in the 1930s and 1940s—before this wholesale transformation in consumption patterns had taken place. The challenge facing states like Illinois—which adopted its sales tax in 1933—is to redefine the sales tax base to include at least some sales of personal, professional, or business services. However, many states have failed to achieve this. A 1996 study by the Federation of Tax Administrators (FTA) found that of 164 potentially taxable services, less than half were taxed by most states. The survey found that 16 of the 45 states (plus Washington, D.C.) levying sales taxes in 1996 included less than 30 of these services in their tax base.

Illinois has done less than almost every other state to include this fast-growing area of consumer spending into the sales tax base. The table below shows how midwestern states have (or have not) integrated various personal and other services into their tax base. Of the 164 services listed by FTA, Illinois taxed just 17 in 1996—most of them residential and business utility services.

The unwillingness of policy makers to extend their sales tax to services is troublesome not only from a revenue perspective, but from an equity perspective. The approach Illinois has taken—uniformly exempting sales of services, while taxing most sales of tangible property—discriminates against taxpayers who prefer to consume commodities and in favor of those who consume services.

## Sales Taxation of Services: A Midwest Comparison

	Illinois	Iowa	Kentucky	Michigan	Missouri	Wisconsin	U.S. Average	Total # of Services Taxable
Utilities	12	13	10	12	8	11	9	16
Personal	1	15	2	4	1	11	6	20
Business	1	18	4	7	2	6	10	34
Computer	1	—	—	1	1	1	2	6
Admission/Amusements	—	13	6	1	11	13	7	14
Professional	—	—	—	—	—	—	1	8
Fabrication, Repair & Installation	1	14	3	2	—	14	8	19
Other	1	21	1	2	5	13	11	47
<b>Total</b>	<b>17</b>	<b>94</b>	<b>26</b>	<b>29</b>	<b>28</b>	<b>69</b>	<b>53</b>	<b>164</b>

SOURCE: Federation of Tax Administrators

<sup>25</sup><http://www.bea.doc.gov/bea/regional/articles/0699rea/maintext.htm>.

There exists broad unanimity among economists that the future vitality of the sales tax depends on its expansion to include services. Yet the same economists stress that any reform which expands the tax base to include services must distinguish between services consumed by *individuals* and services consumed by *businesses*. If the goal of a properly designed sales tax is to tax all (and only) retail sales for final consumption, then the appropriate route to base expansion is not a uniform sales tax on all services, but a uniform tax on all final retail purchases, including all goods and services. Many of the 164 currently untaxed services in the FTA survey are not purchased by residential consumers at all, but are consumed by businesses as an intermediate step in the production process. Taxing the intermediate purchases made by businesses is tempting from a revenue-raising perspective, but is undesirable because it distorts the economic behavior of businesses. A company that finds itself taxed four times in the process of producing a single good (three times on the purchase of intermediate goods and once in the sale of the final product) will face an incentive to escape taxation by vertically integrating and producing intermediate goods itself.

For this reason, the most clear-cut case can be made for extending the sales tax base to personal services such as lodging, admissions, barber and beauty services, and repair services.

## The Importance of Remote Sales

The biggest structural concern facing sales tax administrators is the increasing importance of remote sales—retail transactions in which the seller has no physical presence in the state. A pair of U.S. Supreme Court decisions<sup>26</sup> have created a potentially dangerous loophole for retail merchants operating from outside state lines: Illinois cannot require an out-of-state merchant to collect sales taxes on purchases made by Illinois residents, unless the merchant has a physical presence in Illinois. One reason the Court has refused to force out-of-state merchants to collect sales taxes is the alleged complexity of the various state and local sales tax structures—with so many states, counties and municipalities levying different taxes at different rates with different tax bases, the Court says, it's

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<sup>26</sup>*National Bellas Hess v. Illinois* (1967) and *Quill v. North Dakota* (1992).

### Sales Tax Holidays: A Good Deal?

An increasingly popular approach to sales tax reductions is the temporary “sales tax holiday.” Since New York introduced the practice in 1997, a total of eight states have enacted short-term sales tax exemptions for particular items. Sales tax holidays are generally designed (and marketed) as a means of providing “back to school” sales tax relief, for a period ranging from two days to two weeks, and usually take place during the month of August. These exemptions generally apply only to sales of clothing and/or footwear, although Pennsylvania’s recent sales tax holiday applied only to sales of computers.

Two principal objections can be made to the sales tax holiday approach. First, the short-term tax cuts realized by consumers from these cuts pale in comparison to the overall sales tax burden falling on a state’s taxpayers. The imposition of brief sales tax holidays on particular retail sales may serve to minimize public awareness of the overall inequity of sales taxes. Second, it is not immediately clear how much (if any) of the sales tax cuts due to these holidays will be passed on to consumers, and how much will be retained by retailers.

too cumbersome a task for these retailers to figure out the appropriate tax to collect. For this reason, states have begun to collaborate to simplify state sales tax structures: the idea is that if states simplify the tax bases and tax rates, the Court might allow states to tax remote sales.

### Why should Internet transactions be taxed?

The most appealing solution to the question of the appropriate tax treatment of e-commerce is that it should be treated in exactly the same manner as other retail transactions. That is, retail transactions that are taxable when sold as a “bricks and mortar” transaction should also be taxable when sold via electronic transactions. There are several reasons for taking this approach:

- In general, sales tax exemptions create substantial tax complexity. Sales tax exemptions for groceries require detailed regulations to enforce and define simply because “groceries” are a concept that requires explicit definition. It seems likely that a sales tax exemption for “electronic” transactions would require fairly precise—and contestable—definition as well.

- Exempting e-commerce transactions violates basic tax policy principles of horizontal equity. Retailers who choose (or are forced) to sell their wares primarily in a bricks and mortar setting are unfairly disadvantaged by a policy that exempts e-commerce. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their bricks and mortar purchases. To the extent that Internet access is less available to lower-income taxpayers, exempting Internet purchases from tax probably increases the regressivity of sales taxes, as wealthier taxpayers are able to avoid sales taxes by buying on-line.
- E-commerce exemptions also violate the principle of economic neutrality. By providing tax incentives for retailers to conduct transactions electronically, such exemptions would distort the overall pattern of economic transactions.

currently allow such a credit.<sup>27</sup> This approach offers several advantages over sales tax exemptions: low-income credits can be targeted to state residents only, and can be designed to apply to whichever income groups are deemed worthy of tax relief. The box below shows the details of one such program, the Kansas food sales tax refund. Kansas lawmakers have targeted this rebate to taxpayers over 55 and taxpayers with children under 18. Eligible taxpayers must also earn less than \$25,000 a year.

<b>The Kansas Food Sales Tax Refund</b>	
<b>Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.</b>	
<b>Income Level</b>	<b>Refund</b>
\$0 to \$12,500	\$60 per exemption
\$12,501 to \$25,000	\$30 per exemption
\$25,001 or more	no refund

## Options for Progressive Tax Relief

This chapter has identified two types of exemptions which limit the yield of the Illinois sales tax and exert upward pressure on the tax rate: the preferential rate for food and drugs, and the almost uniform exemption of services from the tax base. Each of these can be addressed in ways to increase the productivity and equity of the tax without adding to the tax burden on low-income Illinoisans.

### Sales Tax Credits

Illinois lawmakers have enacted major sales tax exemptions with the goal of reducing the tax burden on low-income taxpayers. Yet even in cases where the exemptions reduce the overall regressivity of the sales tax (for example, the reduced rates for groceries and medicine), the real impact of the exemptions may be to exert upward pressure on the rate that applies to all other taxable items. This is an unavoidable consequence of sales tax exemptions: these exemptions are granted to everyone purchasing the exempt item, from the poorest worker to the wealthiest Illinoisan to the out-of-state visitor buying groceries.

A less expensive—and better-targeted—approach to low-income sales tax relief is a low-income credit for sales taxes paid. Five states

The current reduced sales tax rates for food and drugs apply to all purchasers of the preferred items, regardless of income level or state of residency. On the other hand, because these credits are generally administered through the state income tax, low-income taxpayers must file a tax form to claim them: taxpayers who aren't aware of such a credit will not claim it. For this reason, any such credit should be publicized sufficiently that low-income taxpayers will be aware of its availability.

### Taxing Services

Lawmakers in many states have recognized the beneficial effects of taxing services on the overall equity of the sales tax and on the yield of the tax. Both are important concerns: the tax system should not punish Illinoisans who are more likely to consume goods than services, and the perceived equity of the tax system suffers when otherwise identical taxpayers are treated differently in this way. There is no sound rationale for taxing the personal consumption expenditures of the predominantly lower-income Illinoisans who focus their spending on tangible goods, while exempting the consumption expenditures of higher-income Illinoisans who are more likely to purchase exempt services.

<sup>27</sup>These states are Idaho, Kansas, Oklahoma, South Dakota, and Wyoming.



While the potential revenue yield of taxing services is immense, this sort of base expansion can also be used in a way that leaves net tax collections unchanged. For example, lawmakers in Minnesota have recently considered proposals which would broadly tax services and use the additional revenue to reduce the state sales tax rate across the board.

## Excise Taxes

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.

The Illinois *cigarette excise tax* was introduced in 1941, at a rate of 2 cents per pack. The rate remained below 10 cents per pack until 1969. Since 1985, however, legislators have enacted a series of substantial cigarette tax hikes, increasing the rate

### Illinois Cigarette Tax Rate Hikes

Year	New Rate Per Pack
1969	12 cents
1985	20 cents
1989	30 cents
1993	44 cents
1997	58 cents

on four separate occasions in the past 15 years. As a result, the tax rate on cigarette sales has more than quadrupled since 1985, representing a 46-cent-per-pack tax increase over that period. And the tax rate has almost doubled since 1993.<sup>28</sup> In 2000, the Illinois cigarette tax was third highest among neighboring states—substantially less than the rates in Michigan and Wisconsin, but significantly more than the rates in Indiana and Missouri—and fifteenth in the nation. In 1993, the state introduced a new *tobacco products tax* on tobacco other than cigarettes.

Illinois levies a separate tax on *telecommunications services*, which raised almost \$800 million for the state in fiscal year 2000. As with other taxes based on consumption, the burden of this tax falls

<sup>28</sup>Almost half of the revenues from these hikes (22 cents' worth) are deposited directly into the state's Common School Fund to pay for the costs of K-12 education, including all of the 14-cent tax increase enacted in the 1997 special legislative session.

disproportionately on the poorest Illinoisans. The rate is currently set at 7 percent of phone charges, as a result of a 2 percent hike in 1997.

The Illinois *motor fuel excise tax* has also been expanded significantly in recent decades. Introduced as a 3 cent-per-gallon tax in 1929, the tax was still just 7.5 cents in 1982. But after a series of hikes during the 1980s, the tax rate almost tripled by 1990, when it was set at the current 19 cents per gallon.

### Cigarette and Gas Taxes in 2000

	Cigarettes (Per Pack)	Gasoline (Per Gallon)
Illinois	58¢	19.0¢
Indiana	15.5¢	15.0¢
Iowa	36¢	20.0¢
Michigan	75¢	19.0¢
Minnesota	48¢	20.0¢
Missouri	17¢	17.0¢
Wisconsin	77¢	27.3¢

Illinois is relatively unusual in that it also applies the statewide 6.25 percent sales tax to gasoline. Illinois is one of only nine states that double taxes gasoline in this manner. Illinois also applies additional storage fees and taxes amounting to 1.1 cents per gallon, designated for state environmental spending.

This multiple-taxation approach to the gas tax is a mixed blessing: because the sales tax on gasoline is an *ad valorem* tax, calculated as a percentage of the sales price, this tax is not subject to the inflationary losses that characterize the gasoline excise tax. Yet the overall regressivity of the gas tax means that revenue growth is derived disproportionately from those least able to afford it.

Illinois levies several excise taxes on sales of *alcoholic beverages*, including beer, wine and distilled liquor. As part of the 1999 "Illinois FIRST" tax increases, each of these taxes were substantially increased. The chart above shows the excise tax rates before and after the 1999 changes. The beer



## Liquor Tax Increases in Fiscal 2000

	Fiscal Year		% Change
	1999	2000	
<b>Beer</b>	7¢	18.5¢	164%
<b>Alcohol:</b>			
<14%	23¢	73¢	217%
14-20%	60¢	73¢	22%
>20%	\$2.00	\$4.50	125%

tax was almost tripled, from 7 cents per gallon to 18.5 cents per gallon. The tax on wine was more than tripled, from 23 to 73 cents per gallon. As a result, the burden of liquor taxes on Illinoisans in fiscal 2000 was *double* the tax burden in the previous year. The tax hikes from these changes fall disproportionately on low-income Illinoisans.

### Excise Taxes and Inflation

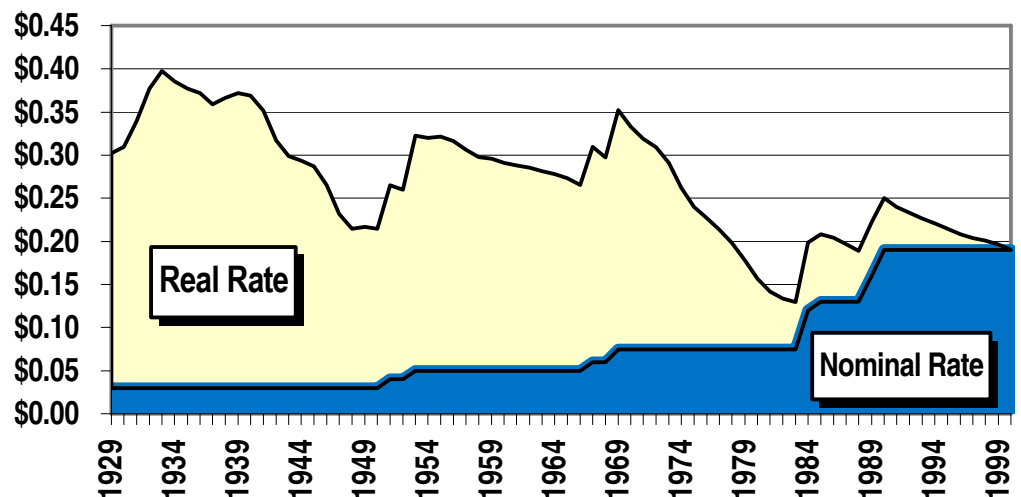
Most retail sales taxes are levied on an *ad valorem* basis—that is, they are calculated as a percentage of the price. This means that inflationary changes in the cost of taxable items are carried through to the *ad valorem* tax, and the yield of the tax increases with inflation. Unlike sales taxes, excise taxes are generally imposed on a *per-unit* basis rather than as a percentage of the sales price: for example, the Illinois cigarette tax is a flat 58 cents per pack, no matter how much the pack of cigarettes costs. The per unit nature of excise taxes means that these taxes inherently grow more slowly than the economy. The yield of a gasoline tax that is levied at 20 cents per gallon will not change when the price of gasoline changes. Excise tax revenue grows (or contracts) only when the volume of the commodity sold grows or contracts, and does not respond to changes in prices. In an inflationary environment, this means that states must continually raise the

rates of excise taxes in order to keep revenues up with inflation. The chart below shows the effect of inflation and legislated changes on the real value (in 2000 dollars) of the state's excise tax on gasoline. The gasoline tax rate has been infrequently increased since the introduction of the tax in 1923. The pattern is that the inflation-adjusted rate increases after a nominal tax hike, and then gradually falls back below its original position. Even with the numerous recent changes in the nominal tax rate, the inflation-adjusted rate is currently less than two thirds of its original value.

### Conclusion

Consumption taxes are the most regressive major tax levied by states. Illinois consumption tax revenues have grown more slowly than in most states during the past two decades—yet the state has one of the highest statutory sales tax rates of any state. This apparent contradiction is due to the narrowness of the state sales tax base. Illinois allows exemptions designed to reduce the regressivity of the tax—such as the reduced rates for food, utilities and drugs—and exemptions which are accidents of history, such as the almost complete exemption of personal and professional services from the tax. Any substantial reform of the Illinois sales tax should address these gaps in the sales tax base.

Effect of Inflation on Excise Taxes: Illinois' Gasoline Excise Tax in Nominal and Inflation-Adjusted 2000 Dollars



# THE ILLINOIS CORPORATE INCOME TAX

The corporate income tax is an important tool for state tax progressivity. In the 45 states that levy one, a corporate income tax helps offset the regressivity of the property and sales taxes which make up the bulk of state and local tax revenues. Illinois lawmakers have enacted a set of specialized tax breaks that undercut this important tax base. Before enacting any further tax incentives, policy makers should investigate whether the existing tax incentives are achieving their desired effect—and whether these tax breaks are undermining the equity of the state corporate income tax by creating the phenomenon of zero-tax corporations.

## Advantages of the Corporate Income Tax

Unique among the major taxes levied by state governments, the corporate income tax is a progressive tax that is largely exported to residents of other states. Both of these traits—its progressivity and its exportability—are due to the fact that corporate income taxes are generally passed through to owners of corporate stock.

Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy.

Because many corporations with Illinois operations have shareholders throughout the nation, the burden of the corporate income tax is distributed to other states depending on where shareholders live. The ability to export part of the corporate income tax burden in this way is important because out-of-state shareholders benefit indirectly from the public services provided to Illinois corporations.

The corporate income tax is a relatively recent addition to the Illinois tax structure. Introduced in 1969 along with the personal income tax, the corporate income tax is levied at a flat rate of 4.8 percent. The ability of Illinois lawmakers to raise the corporate tax rate is limited because the Illinois constitution requires a flat-rate corporate income tax, and limits this rate to 180 percent of the rate on personal income.

In theory, the Illinois corporate income tax is based on corporate profits. Yet because the state closely follows federal corporate income tax rules, the tax base is subject to many loopholes that allow

corporations to pay far less than they would if they were being taxed on actual profits. And Illinois lawmakers have enacted their own additional corporate tax breaks that further erode the tax base, including a single sales factor provision that greatly reduces the amount of corporate income attributable to Illinois for some large corporations which sell heavily outside the state, and a host of tax credits and deductions that can be used to reduce state tax liability.

## The Single Sales Factor

States can only tax corporate income that is reasonably related to the activities of the corporation within its boundaries. This means that states must distinguish between in-state and out-of-state taxable income. In general, states have accomplished this by computing the proportion of a firm's total sales, property, and payroll located in the state. The percentage of in-state taxable income is then calculated as the average of these three proportions. This “three-factor” formula has been the approach to corporate income apportionment most frequently used by states since the 1950s.

Corporate Income Apportionment				
	Property	Payroll	Sales	Total
Standard				
Three-factor	1/3	1/3	1/3	1
Illinois Pre-2000	1/6	1/6	2/3	1
Illinois Post-2000	0	0	1	1

In recent years, two deviations from the three-factor approach have become more common: heavier weighting of one of the three factors, and entirely eliminating one or more factors. Before 2000, Illinois's system took the former approach by double-weighting the sales factor; since 2000, Illinois has eliminated the property and payroll factors, going to the *single sales factor* (SSF) approach. The goal of the 1999 legislation creating the single sales factor formula was to encourage the growth of manufac-

turing industries in the state. Since SSF reduces the income tax burden on firms that have a relatively large share of their payroll and property in Illinois while making most of their sales out of state, this approach might seem tailored toward encouraging the growth of Illinois industry. However, any positive effect this move might have on manufacturing industries is probably offset by two factors:

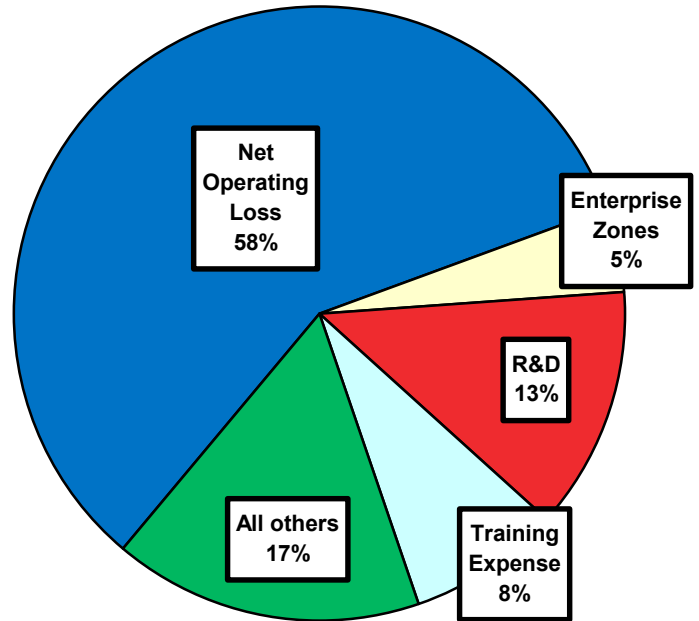
- Every other neighboring state now applies a higher weight to the sales factor.<sup>29</sup> As surrounding states move toward uniformly adopting the single sales factor, the locational incentive generated by SSF in any particular midwestern state will disappear, since the rest of them already offer the same incentive. The unhappy result of this race to the bottom is that states offering the single sales factor pay all of its costs in the form of reduced corporate income tax revenues, but enjoy none of the locational incentives SSF is said to offer.
- For each corporation that benefits from SSF because most of its sales are out of state, there are other corporations that will be punished by SSF because their sales are mostly *in* Illinois. Smaller corporations that tend to make most or all of their sales within Illinois will actually experience a tax *increase* under the single sales factor—hardly the wisest approach to economic development. As a result, adoption of the SSF ultimately benefits some corporations while punishing others in an arbitrary way.

Perhaps most troubling, there is some evidence that the tax benefits from the single sales factor may be dominated by a few of the very largest manufacturers. One 1997 analysis found that more than 60 percent of the tax reductions from the single sales factor change would accrue to a small group of five corporations.<sup>30</sup>

<sup>29</sup>Among neighboring states, Iowa and Missouri use the single sales factor. Michigan apportions 90 percent of in-state income according to sales—as close as a state can get to enacting a single sales factor without actually doing it. Indiana, Wisconsin and Kentucky use a double-weighted sales formula, and legislation enacted in 1999 (HF 2420) changed Minnesota’s formula from 70-15-15 to 75-12.5-12.5 (where the 75% is sales).

<sup>30</sup>Copley News Service, Apr. 27, 1998, Bernard Schoenburg.

**Corporate Tax Breaks in Fiscal 2000**



### Illinois Tax Breaks: Bang for the Buck?

Since 1991, Illinois has allowed corporations to claim a *Research and Development tax credit* based on the federal R&D credit. The credit is 6.5 percent of qualifying research and development expenditures—that is, a dollar-for-dollar reduction of a company’s corporate income tax bill equal to 6.5 percent of eligible research and development expenses. This credit reduced state tax collections by \$27 million in fiscal year 2000.

The theory behind the R&D credit is that it encourages corporations to engage in research and development expenditures that will produce useful technological innovations, new products, and therefore new jobs. Unfortunately, the credit has three critical problems.

First, a credit that rewards risky yet innovative research must determine what such research looks like. Yet federal rule-makers have struggled for the past fifteen years to come up with a sensible test for eligible research. The uncertainty surrounding these eligibility rules on the federal level is a problem for Illinois, since the state credit borrows from the federal credit’s rules.

Second—and more important—the R&D credit, like all credits designed to encourage particular corporate behaviors, may often reward firms for engaging in investments or research that they would have done anyway if the credits did not exist. There

is no test to verify that the research would not have taken place “but for” the credit.

Third, there is no guarantee that the real jobs resulting from the new products will be created in Illinois. Indeed, a pharmaceutical company taking credit for research in Naperville may patent a product and produce it in El Paso or Singapore.

Illinois corporations are also allowed a generous *net operating loss deduction*. This provision allows corporations to apply any unused deductions against future tax liability and (to a lesser extent) past tax liability. Illinois corporations can carry operating losses back two years and forward twenty years. Each of these provisions is generous by comparison to the rules used by many other states. More than half of the 45 states with corporate income taxes allowed a carryback of less than two years in 2001—and 25 did not allow net operating loss carrybacks at all. Similarly, the 20-year carryforward allowed by Illinois is more generous than 21 other states.

The net effect of the various tax credits used to reduce Illinois corporate income tax liability is to narrow the tax base substantially. The Department of Revenue estimates that in fiscal year 2000, Illinois corporations claimed tax breaks equal to almost fifteen percent of corporate income tax collections. Just four of the largest tax breaks—the net operating loss deduction, the R&D tax credit, the enterprise zone investment credit, and the training expense credit—accounted for more than 80 percent of these tax expenditures in fiscal year 2000. By itself, the net operating loss deduction accounted for more than half of these corporate tax breaks.

## Do Corporate Tax Incentives Work?

These tax breaks erode the state’s corporate income tax base. But supporters of these breaks often argue that to focus on the direct revenue loss from these tax breaks is to miss the point entirely: the stated goal of these tax loopholes is usually to encourage economic growth in Illinois. Still, there is little empirical evidence to suggest that the level of state taxation has a measurable impact on a state’s economic well-being—or on the location decisions made by businesses. One comprehensive review<sup>31</sup> of the economic literature on this issue found that:

<sup>31</sup>*Do State and Local Tax Incentives Work?*, Robert G. Lynch, Economic Policy Institute, 1996.

- There is no evidence that state and local tax cuts, when paid for by reducing public services, either stimulate economic activity or create jobs.
- There is little indication that state and local tax levels affect business location decisions.
- Factors such as the cost and quality of labor, the quality of public services (schools, roads and highways, sewer systems, recreational facilities, higher education, health services, etc.), the proximity to markets, and the access to raw materials and supplies are more important than tax incentives in business location decisions.
- There is little evidence that job losses or job transfers from one state to another are a consequence of business tax incentives.

Although it is hard to quantify any effect that corporate tax breaks may have on economic development, it is comparatively easy to determine the effect these breaks have on state revenues, as the following chart demonstrates. However, there is little information available about how these tax breaks affect individual corporations.

## Do Illinois Corporations Pay Their Fair Share?

Even as the overall importance of corporate income tax revenues have declined nationally, an increasing number of horror stories are being told about the impact of federal tax breaks on individual companies.

Federal Corporate Income Taxes Paid by Navistar, 1996-1998				
	1996	1997	1998	3 year total
Profit Before Tax (\$-millions)	\$ 106	\$ 236	\$ 400	\$ 742
Federal Income Tax	\$ 1	\$ 8	\$ 4	\$ 13
Effective Tax Rate	0.9%	3.4%	1.0%	1.8%

Source: "Corporate Income Taxes in the 1990s," ITEP (October 2000), <http://www.itepnet.org/corp00pr.htm>

A recent ITEP analysis of 250 of the largest and most profitable corporations in America found that 133 of these corporations—more than half—paid

less than half of the nominal federal corporate income tax rate of 35 percent in at least one year between 1996 and 1998, and that 41 of these companies actually received net tax rebates from the federal government during this period. The same federal loopholes also have an effect on the tax payments of Illinois corporations.

The ITEP analysis was made possible by the fact that publicly held corporations must disclose information about their federal corporate income tax payments to shareholders and the Securities and Exchange Commission (SEC). As a result, we know that some large Illinois-based employers have been able to take advantage of loopholes in the federal corporate income tax. For example, ITEP's study found that Warrenville-based Navistar Corporation earned \$742 million in pretax profits between 1996 and 1998, but paid just \$13 million in federal income taxes. The effective tax rate paid by Navistar during this three-year period was 1.8 percent—far below the statutory federal rate of 35 percent, and substantially lower than the average effective tax rate paid by low-income Illinoisans estimated in Chapter Two of this study.

If Navistar and 132 other corporations were this successful in reducing their tax liability through completely legal tax loopholes on the federal level, it seems reasonable to assume that corporations may be finding loopholes at the state level as well. Unfortunately, neither the SEC nor most state governments require corporations to release information on the loopholes they have claimed.

The Illinois Department of Revenue's annual "Tax Expenditure Report" is an important step toward greater transparency and accountability in the process of making Illinois tax policy, because it reports the aggregate cost of the tax breaks enjoyed by corporations operating in Illinois. Without the Tax Expenditure Report's wealth of information on these tax breaks, we would know very little about the extent to which the corporate tax base has been reduced by these loopholes. Yet this data tells us nothing about the taxpaying behavior of individual corporations (or about the amount of tax credits each corporation claims), so it is currently difficult to know how big an impact these loopholes are having on the effective tax rate paid by profitable in-state corporations.

As a result, it's not currently possible to determine whether the loopholes described here have spawned an epidemic of state tax avoidance. However, the recent downturn in federal corporate tax payments, combined with the introduction of the single sales factor in Illinois, suggests that more open disclosure of state corporate tax information might be warranted. As ITEP's Good Jobs First project has documented, nine states now require corporations to disclose some information about the state or local tax breaks they receive. Most recently, in the fall of 2001 North Carolina legislators amended the state's tax-subsidy law to require extensive company-specific reporting of tax credits. The disclosure requirements cover tax credits for training, research and development, and machinery and equipment credits. It also requires disclosure, when a company claims development zone credits, of how many of the new jobs went to zone residents. This sort of disclosure requirement could help Illinois lawmakers determine the overall effect of these tax breaks on individual companies' tax-paying behavior.

## Conclusion

The Illinois corporate income tax is an important source of tax progressivity. In the absence of a healthy corporate income tax, state lawmakers must increase their reliance on other tax sources—including individual income and property taxes. Sadly, in recent years Illinois has joined the race to the bottom among midwestern states offering broad, uneven corporate tax breaks that fail to ensure their stated goals of economic development.

Data from the Department of Revenue allow us to confirm that these tax breaks substantially reduce the corporate income tax base—forcing the state to look elsewhere for needed tax revenues in an economic slowdown. But we know very little about which companies have benefitted most from these tax breaks, and therefore it is impossible to know if they have fostered job creation or retention. As the specter of widespread corporate tax avoidance reappears on the federal level, Illinois lawmakers should assess the aggregate impact of these corporate tax breaks on individual corporations by requiring disclosure of state tax incentives.



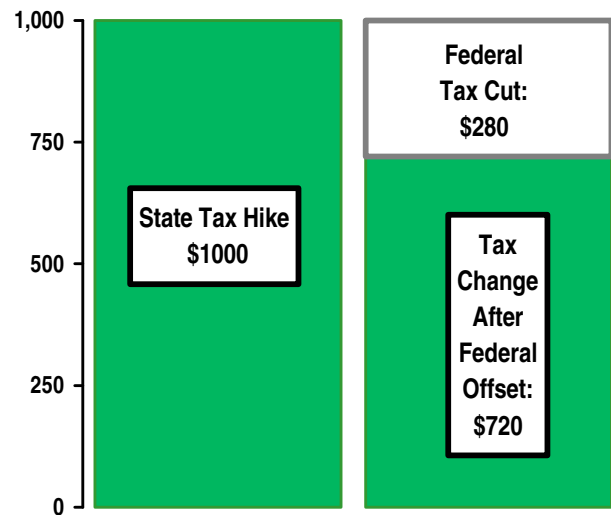
# TAX REFORM OPTIONS FOR ILLINOIS

Legislators may choose to reform tax structures for a number of reasons. They may find that the tax system raises too little money—or too much. They may wish to change the balance between different taxes. Or they may find that the tax system discriminates between similarly situated taxpayers. This chapter includes descriptions of thirty distinct options for addressing these problems. Each option is accompanied by a **distributional analysis** which measures the net effect on Illinoisans' tax burden and a **revenue estimate** for calendar year 2000. The proposals are grouped into three general categories: revenue-raising options, revenue-reducing options, and revenue-neutral options.

The bar chart to the right shows the impact of these options on each Illinois income group, expressed as a percentage of personal income. The solid portion of each bar represents the state tax change (after taking federal tax changes into account) for each income group. Where there are federal tax ramifications stemming from a proposal (because of federal itemized deductions for Illinois income and property taxes paid), the charts also include grey lines that show the proposal's effects *before* consideration of the federal offset. We have presented our data in this way because for those who itemize deductions on their federal tax return, changes in state income taxes or property taxes can produce substantial offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Illinoisans, including federal and state taxes. The following example shows how to interpret these charts.

Suppose an itemizing Illinois taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 increase in Illinois income taxes. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer's income will be subject to federal tax after the Illinois tax cut. Since this untaxed income is taxed at 28 percent, federal tax liability decreases by \$280. So the net *overall* tax hike for this itemizing Illinois taxpayer from a \$1,000 hike in state tax

liability is actually \$720, not \$1000. Our distributional analysis of this proposal (below) shows that taxpayers do not pay the full \$1,000 tax hike, since \$280 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax



impact of this proposal (on the left) would substantially overestimate the additional tax burden on Illinoisans from this proposal.

If, on the other hand, the same taxpayer experienced a \$1,000 sales tax hike, federal tax payments would not change, because sales taxes cannot be deducted by federal itemizers. This means that the entire \$1,000 tax hike would be paid by the taxpayer. The choice between sales and income tax hikes does not affect state revenues—the state receives an extra \$1,000 with either approach—but the taxpayer fares much worse under the income tax proposal than under the sales tax proposal.

This relationship holds true for income and property tax *reductions*, as well: a cut in these taxes that is targeted to federal itemizers will be partially offset by federal income tax increases. If these tax cuts are clearly targeted toward wealthy taxpayers who pay at the top federal rates (as is the case with the capital gains tax cut in Option 25), more than a third of the state tax cuts may go directly to the coffers of the federal government rather than going to the pockets of Illinoisans. It hardly seems likely that Illinois lawmakers would intentionally design a



tax cut that effectively throws away a third of its cost—yet this is the effect of any income tax break that targets its benefits to the best-off Illinoisans.

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## Revenue-Raising Options

In this section we offer several revenue-raising tax reform options. The options presented here include *base-broadening* measures designed to increase the yield of Illinois taxes without raising rates (including Option 5, which would eliminate tax preferences for retirement benefits, and Option 10, which would extend the 6.25 percent statewide sales tax to sales of groceries); *rate hike* measures which would simply increase tax rates without affecting the tax base; and *targeted* measures which would narrow the scope of existing tax preferences.

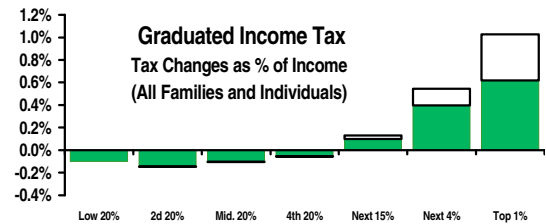
### 1. Graduated Income Tax

**Principal Features**

- Replaces the flat-rate income tax with a 3-tier graduated rate ranging from 2.7 percent to 4.25 percent.
- Cuts taxes for 60 percent of Illinoisans.
- Increases Illinois taxes by \$1 billion.
- Reduces federal taxes by \$400 million.
- Requires a constitutional amendment.

**Discussion**

Illinois is one of only six states to impose a flat-rate income tax—and has the second-lowest tax rate of any flat tax state. This option creates a new three-rate income tax, with rates of 2.75, 3.5, and 4.25 percent. Because the first \$50,000 of taxable income would be taxed at a lower rate for joint filers (the first \$25,000 for single filers), a majority of Illinoisans would see a net tax cut under this proposal. Twenty-one percent of Illinoisans would experience a state tax hike, but about 40 percent of the tax increase would be offset by federal tax cuts. This option takes advantage of the interaction between state and federal income taxes by *lowering* taxes on those Illinoisans least likely to itemize their federal taxes and *increasing* taxes on those Illinoisans most likely to itemize.



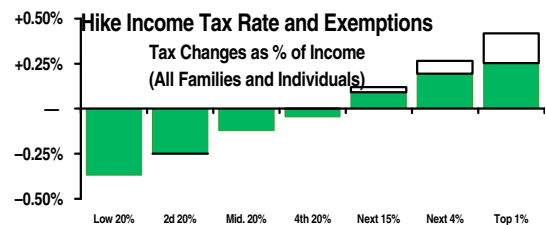
### 2. Increase Income Tax Rate, Increase Personal Exemption to \$5,000

**Principal Features**

- Increases the flat income tax rate to 3.5 percent.
- Increases the personal and dependent exemption to \$5,000.
- Cuts taxes for 45 percent of Illinoisans.
- Increases Illinois income taxes by \$370 million.
- Reduces federal taxes by \$180 million.

**Discussion**

This option increases the progressivity of the Illinois income tax by increasing the flat tax rate to 3.5 percent and increasing the personal and dependent exemptions to \$5,000. This change results in a net tax cut, on average, for every income group except the wealthiest twenty percent, bringing in \$370 million in new Illinois revenue and reducing federal tax payments by Illinoisans by \$180 million. The federal government picks up more than 40 percent of the tab for this tax increase.



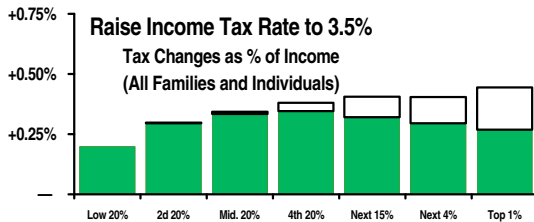
### 3. Raise Personal Income Tax Rate to 3.5%

#### Principal Features

- Increases Illinois taxes by \$1.375 billion.
- Reduces federal taxes by \$285 million.
- Moderately progressive tax increase.

#### Discussion

This change would increase the progressivity of the overall Illinois tax system, but would result in a tax hike for all income-tax payers. Twenty percent of the state tax hike would be paid for directly by the federal government in the form of federal income tax cuts for Illinois itemizers.



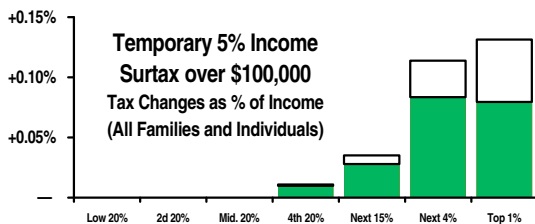
### 4. Impose a Temporary 5% Surtax on Taxable Income Over \$100,000

#### Principal Features

- Increases Illinois taxes by \$190 million.
- Reduces federal taxes by \$35 million.

#### Discussion

This proposal imposes a one-time flat 5 percent surtax on Illinois taxpayers with incomes over \$60,000 (for singles) and \$120,000 (for joint filers). Just under 10 percent of taxpayers would have been affected by this option in tax year 2000. A substantial percentage of the state tax hike from this option would be offset by lower federal income tax payments for Illinois itemizers.



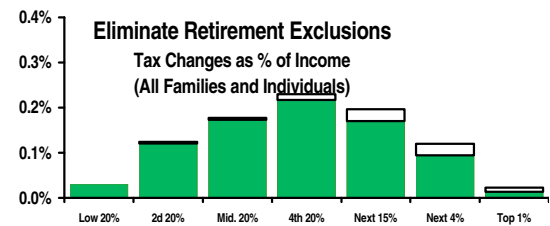
### 5. Eliminate Pension and Social Security Exclusions

#### Principal Features

- Increases Illinois taxes by \$500 million.
- Reduces federal taxes by \$50 million.

#### Discussion

This proposal increases the yield of the personal income taxes by removing two poorly targeted—and expensive—exemptions for retirement income. Because the wealthier taxpayers predominantly affected by this option are more likely to itemize their federal taxes, federal taxes paid by Illinoisans would decline by \$50 million under this option.



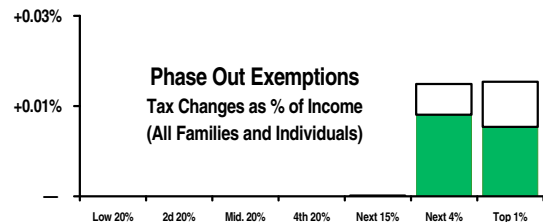
### 6. Phase Out Personal Exemptions

#### Principal Features

- Disallows personal exemptions for taxpayers with incomes over \$128,950.
- Increases Illinois taxes by \$20 million.
- Decreases federal taxes by \$7 million.
- Progressive tax increase.

#### Discussion

This option raises \$20 million. The option phases out the value of the \$2,000 personal exemption over an income range starting at \$128,950 for singles and \$193,400 for married couples. Less than 3 percent of Illinoisans would be affected by this change.



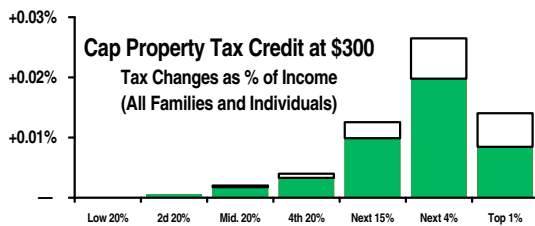
## 7. Cap the 5% Property Tax Credit at \$300

### Principal Features

- Limits the value of the income-tax-based property tax credit to \$300.
- Improves the targeting of the Illinois credit.
- Increases Illinois income taxes by \$38 million.
- Reduces federal taxes by \$10 million.

### Discussion

This option increases the progressivity of the Illinois tax system by placing a ceiling on the dollar amount of the 5 percent property tax credit claimed on Illinois income tax forms. This limitation primarily affects wealthier Illinoisans: 90 percent of the Illinois tax hike under this proposal would be paid by the wealthiest 20 percent of state residents, and the poorest 60 percent of Illinoisans would pay less than 3 percent of the state tax hike. Many lower-income taxpayers are unaffected because they cannot claim the full \$500 credit under current law. Because state income taxes are deductible on federal income tax forms for Illinois itemizers, this option reduces federal income taxes by \$10 million.



## 8. Increase Property Tax Homestead Exemption, Increase Personal Exemption, Increase Income Tax Rate

### Principal Features

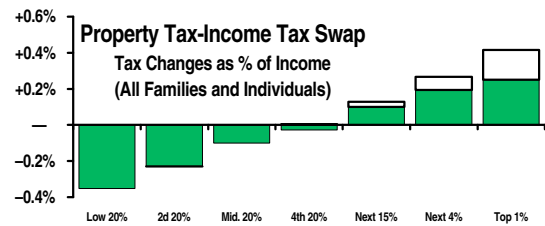
- Increase homestead exemption from \$3,500 (\$4,500 in Cook County) to \$7,000 state-wide.
- Increase personal and dependent exemption to \$5,000, increase personal income tax rate to 3.5 percent.
- Increases Illinois taxes by \$400 million.

### Discussion

This option takes a step toward the sort of tax swap discussed through the 1990s in Illinois by increasing the property tax homestead exemption

to a flat \$7,000. The income tax personal and dependent exemption is increased to \$5,000, and the income tax rate is increased to 3.5 percent.

This option increases state revenues by \$400 million, but more than 40 percent of the tax hike is offset by a federal tax cut for itemizers. Federal taxes fall by \$190 million under this proposal. Only the wealthiest twenty percent of taxpayers, on average, experience a state tax hike under this proposal.



## 9. Cigarette Tax Increase

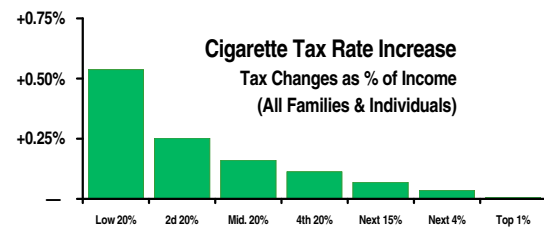
### Principal Features

- Raise cigarette tax by \$0.42 cents per pack so that the rate reaches \$1.00 per pack.
- Regressive tax increase.
- Increases Illinois taxes by \$325 million.
- Federal taxes are not affected by this change.

### Discussion

The Illinois cigarette tax rate is already comparatively high—and has doubled since 1993. By increasing the tax rate to \$1.00 per pack from the current \$0.58, this option would obviously exacerbate regressivity. Some argue, however that increases in cigarette taxes may discourage smoking. Raising the tax to \$1.00 could have this effect, although the evidence is mixed at best.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax burden would be offset by federal tax cuts.



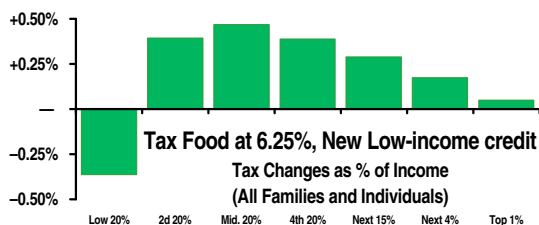
## 10. Extend State Sales Tax to Groceries, Introduce Low-Income Food Tax Credit

### Principal Features

- Applies the full 6.25 percent state sales tax to food.
- Provides targeted food tax relief to low-income Illinoisans.
- Increases Illinois taxes by \$800 million.

### Discussion

This option broadens the Illinois state sales tax base by applying the same 6.25 percent rate to sales of groceries as is currently applied to most other base items. The sales tax hike on lower-income taxpayers is offset by a grocery tax credit.



## 11. Increase Cigarette Tax and Earned Income Tax Credit

### Principal Features

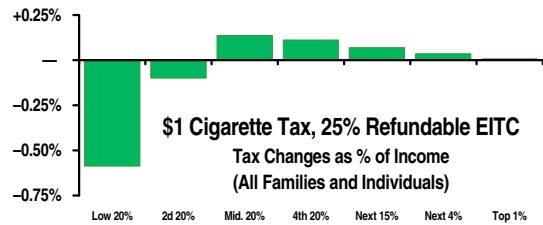
- Increases regressive cigarette taxes to \$1.00 per pack.
- Offsets impact of cigarette tax hike with an expanded Earned Income Tax Credit.
- Increases Illinois taxes by \$115 million.

### Discussion

This option includes the 42-cent cigarette tax hike modeled in Option 9 and the 30 percent refundable Earned Income Tax Credit modeled in Option 21.

Because excise tax increases—especially cigarette taxes—hit low-income taxpayers most heavily as a share of personal income, low-income tax credits may be used to offset some of the additional tax burden. The option shown actually results in a net tax cut, on average, for the poorest 40 percent of Illinoisans.

## 12. Expand Sales Tax Base to Include All Services

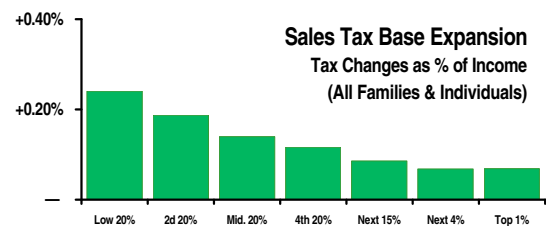


### Principal Features

- Includes many personal services in the state sales tax base.
- Impact of tax increase is greatest for low- and middle-income taxpayers.
- Increases Illinois taxes by \$330 million.

### Discussion

This option augments the state sales tax base by taxing personal services such as haircuts, repair services, and club membership dues and fees. The option raises \$330 million. Although adding services to the sales tax base makes the sales tax regressive, the impact of this tax option is nonetheless clearly regressive compared to income- or property-tax based options; the poorest 20 percent of Illinois taxpayers would pay an extra 0.6 percent of their income in taxes under this proposal, while the wealthiest one percent of taxpayers would pay less than 0.1 percent more as a share of income. If such a sales tax expansion includes business services, it could encourage businesses to produce these services themselves, leading to artificially high levels of vertical integration.



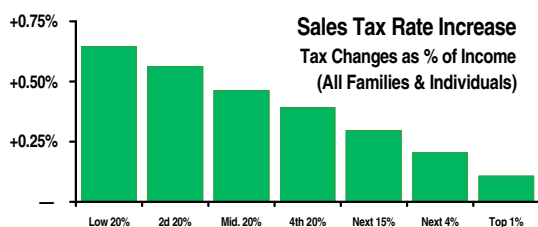
### 13. Raise General Sales Tax Rate

#### Principal Features

- Raises state sales tax rate from 6.25 percent to 7.25 percent.
- Regressive tax increase.
- Increases Illinois taxes by \$1.3 billion.

#### Discussion

The general sales tax is the least progressive major tax levied by the state—and Illinois already has one of the highest state sales tax rates in the nation. Because sales taxes are not deductible on federal income tax forms, none of the added sales tax burden would be offset by federal tax cuts.



### Revenue-Neutral Options

Legislators nationwide are showing an increasing interest in revenue-neutral tax reforms. These reforms are often designed to shift the state and local tax burden from one tax base to another—or to broaden the base of a particular tax while simultaneously dropping the tax rate. In this section we offer several tax reforms that broaden or shift the tax base, leaving Illinois tax collections approximately unchanged in 2000—but which (in some cases) affect federal taxes paid by Illinois residents, while shifting the distribution of tax liability between income groups.

### 14. Increase Income Tax Rate and Exemptions

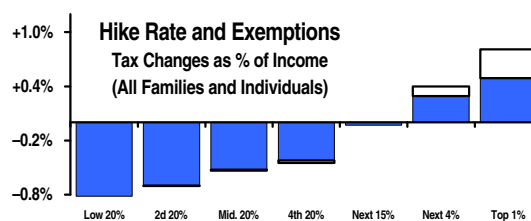
#### Principal Features

- Increases personal exemption from \$2,000 to \$12,000 and dependent exemptions from \$2,000 to \$4,800.
- Increases income tax rate from 3 to 4 percent.

- Progressive impact on tax burden.
- Reduces federal taxes by \$275 million.

#### Discussion

This option makes the nominally flat Illinois income tax more like a typical progressive tax in its incidence. The option increases the state income tax rate from 3 percent to 4 percent. While such a change would, in isolation, constitute a mildly progressive across-the-board tax increase, the rate hike on low- and middle-income taxpayers is completely offset by an increase in the personal exemption from \$2,000 to \$12,000, along with a simultaneous increase in the dependent exemption from \$2,000 to \$4,800.



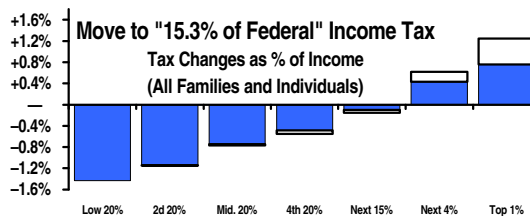
### 15. Move to “15.3 Percent of Federal” Personal Income Tax

#### Principal Features

- Simplifies Illinois income tax calculation.
- Defines Illinois income tax liability as 15.3 percent of federal tax liability.
- Reduces federal taxes by \$360 million.

#### Discussion

This reform would help simplify the Illinois income tax—under a percent of federal system, taxpayers would simply multiply their federal tax liability by 15.3 percent to calculate their state income tax liability. For most taxpayers, this would reduce the income tax to three steps and just two lines. This



option has a progressive impact, since the tax is calculated by applying a percentage of a progressive tax. While state taxes would be unchanged by this



proposal, federal taxes paid by Illinois residents would fall by \$360 million.

## 16. Simplify Tax Filing for Elderly Taxpayers

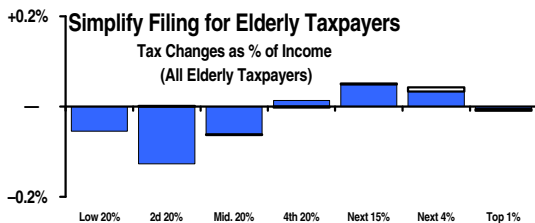
### Principal Features

- Eliminates Illinois exemptions for pension and Social Security benefits.
- Provides extra over-55 all-source exemption to compensate.
- Reduces federal taxes by \$4 million.

### Discussion

This option provides progressive tax relief, while simplifying the tax-filing process for elderly Illinois residents. The option eliminates special Illinois exemptions for pension and Social Security income, treating both income sources just as they are treated on the federal tax form. The extra Illinois revenue from eliminating these exemptions is used to create a special over-55 per-filer exemption of \$12,000.

For elderly taxpayers, this option simplifies the tax filing process by eliminating differences between federal and Illinois AGI. It is fiscally responsible, since it costs the state nothing to enact. This option increases the progressivity of the tax system by cutting taxes on the poorest 60 percent of taxpayers over 55. And it increases the horizontal equity of the tax system by treating all elderly taxpayers at a given income level the same, no matter what their income source. The tax hike on the best-off five percent is partially offset by a decrease of \$4 million in total federal tax liability.



## 17. Increase Homestead Exemption, Increase Personal Income Tax

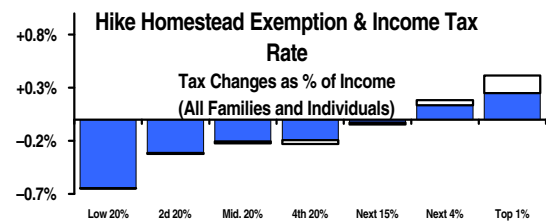
### Principal Features

- Increases homestead exemption from \$3,500 to \$10,000.
- Increases income tax rate from 3 percent to 3.5 percent.
- Reduces federal taxes by \$100 million.

### Discussion

Like Option 8, this option represents a shift away from regressive property taxes, and toward progressive income taxes, as a revenue source. Unlike Option 8, the approach modeled here leaves net Illinois taxes unchanged, and simply shifts tax dollars from the property tax to the income tax. A reduction in the moderately regressive property tax is offset by an increase in the income tax rate. Every income group except the wealthiest twenty percent sees, on average, a net tax cut under this option.

The property tax reduction element of this proposal extends the homestead exemption amount to \$10,000. As explained in the text accompanying Option 28, this exemption increase will have a progressive impact on the tax burden. While this approach leaves total Illinois state tax revenues unchanged, it results in a net federal tax *cut* of \$100 million for Illinoisans.



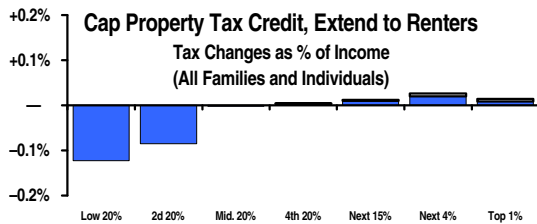
## 18. Cap Property Tax Credit, Make Available to Renters

### Principal Features

- Following the example of the one-time property tax rebate offered in 1999, this option would cap the existing property tax credit at \$300 per return.
- The revenue windfall from capping the property tax credit is used to provide a property tax relief credit for renters.
- Reduces federal taxes by \$10 million.

## Discussion

This option addresses one of the principal inequities in the Illinois property tax—the lack of major property tax relief mechanisms directed toward non-elderly renters. Because it shifts the property tax burden from poorer taxpayers—who tend not to itemize their federal tax returns—to wealthier taxpayers who do generally itemize, this shift has the effect of reducing federal taxes paid by Illinois residents. Thus, while the option leaves Illinois tax collections unchanged, it reduces the *overall* taxes paid by Illinois taxpayers.



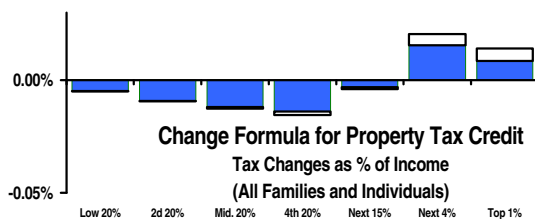
## 19. Change Formula for Property Tax Credit

### Principal Features

- Caps property tax credit at \$300 per return.
- Increases percentage of property tax rebated to 5.8 percent.

### Discussion

This option makes the property tax credit better targeted to achieve low- and middle-income property tax relief. The 5 percent property tax credit, which currently has no dollar limit, is capped at \$300 per return, and the 5 percent refund rate is increased to 5.8 percent. This approach provides substantial tax relief for lower-income Illinoisans while leaving the total Illinois tax burden



unchanged—and cuts the federal taxes paid by Illinoisans by over \$4 million.

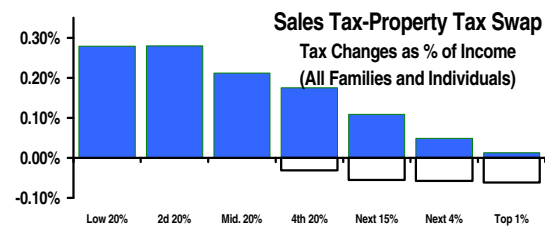
## 20. Increase sales tax, cut property tax

### Principal Features

- Increases statewide sales tax rate from 6.25 percent to 7.25 percent.
- Decreases Illinois's reliance on property tax revenues.
- Increases federal taxes by \$130 million.

### Discussion

This option raises taxes on Illinoisans at all levels. While Illinois property taxes are regressive, the state's sales tax is marginally more regressive. This means that a revenue-neutral property-tax-for-sales-tax swap will increase the regressivity of the tax system. Federal taxes would increase by \$130 million as a result of this change, since property taxes are deductible for federal itemizers but sales taxes are not. This is important for wealthier taxpayers, who would see a net state tax *cut* under this option but would have that cut completely offset by increasing federal tax liability. Finally, since sales taxes are more likely to fall on in-state residents than are property taxes, this option shifts a greater share of the Illinois tax burden onto Illinoisans.



## Revenue-Reducing Options

This section outlines several revenue-reducing tax reform options. All of these proposals reduce the aggregate Illinois tax burden—and reduce state and local funds available for providing public services. Some of these options combine revenue reductions with base broadening. Others simply narrow the base or reduce tax rates.

## 21. Increase The Earned Income Tax Credit

### Principal Features

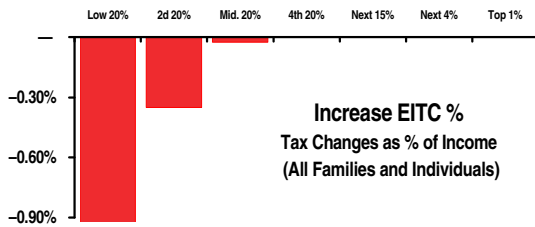
- Increases the Illinois Earned Income Tax Credit (EITC) from 5 percent to 30 percent of the federal EITC.

- The currently nonrefundable EITC is made refundable.
- Reduces Illinois taxes by \$210 million.
- Targeted to lower-income working families.

**Discussion**

Illinois’s 5 percent EITC, created in 1999, is the smallest such credit currently available. The Illinois EITC is also non-refundable, a trait shared by only six other state EITCs. This option corrects both of these shortcomings by increasing the value of the credit to 30 percent of the federal credit and by making the credit refundable.

Because this credit only affects lower-income families who rarely itemize deductions on their federal return, the impact of this option on federal taxes paid by Illinoisans is negligible.



**22. Dependent Care Credit Based on the Federal Credit**

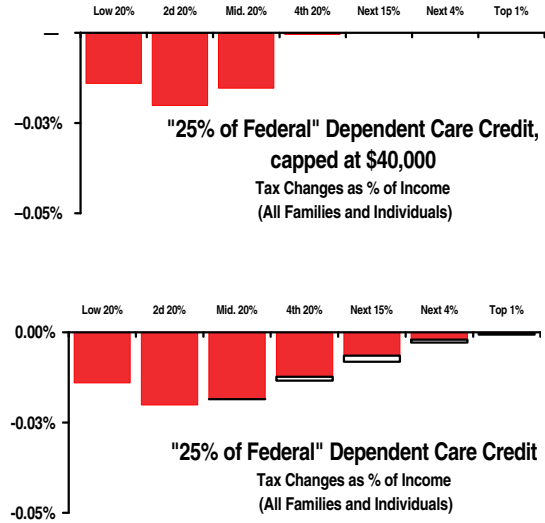
**Principal Features**

- Creates a nonrefundable dependent care credit equal to 25 percent of the federal credit, capped at \$40,000 of income.
- Reduces Illinois taxes by \$13 million, or \$32 million if the \$40,000 limit is eliminated.
- Larger tax cuts for lower- and middle-income taxpayers.
- No change in federal taxes paid. If the \$40,000 limit is eliminated, federal taxes increase by \$3 million.

**Discussion**

The federal government allows a non-refundable income tax credit of up to 30 percent of allowable child care expenses. The federal credit is reduced to 20 percent of expenses for taxpayers earning over \$28,000, but is available to taxpayers at all income levels. This makes the dependent care credit more expensive. Removing the income eligibility cutoff of \$40,000 per family would increase the estimated

cost of this credit from \$13 million to \$32 million in tax year 2000.



**23. Increase the Personal Exemption to Conform to the Federal Exemption**

**Principal Features**

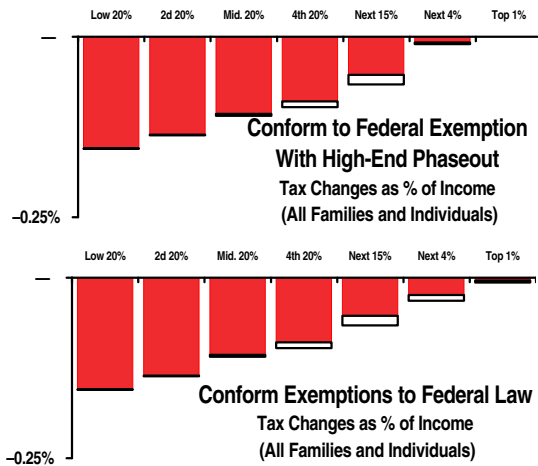
- Increases the personal exemption from \$2,000 per person to \$2,800 per person.
- Reduces Illinois taxes by \$235 million (\$210 million if phased out at high incomes).
- Provides greater tax cuts for lower-income taxpayers.
- Increases federal taxes by \$23 million (\$12 million if exemption is phased out at high incomes).

**Discussion**

Illinois allows a \$2,000 personal exemption for each member of a family, and an additional \$1,000 exemption for taxpayers over age 65. This option increases the tax year 2000 personal exemption from \$2,000 to \$2,800—the amount allowed on federal income tax forms in 2000. This option has a progressive impact, although the 18 percent of low-income families that currently do not owe income tax would not benefit from the exemption hike.

Because a simple exemption hike allows a substantial tax cut for wealthier taxpayers, a portion of the upper-income tax break goes to the federal government in the form of higher federal income tax payments. This result could be avoided by creating a personal exemption phase-out similar to the federal phase-out.

If this change were enacted by explicitly tying the state personal exemption to the federal personal exemption for each tax year, the problem of inflationary loss in the personal exemption would be eliminated.



## 24. Personal Income Tax Rate Cut

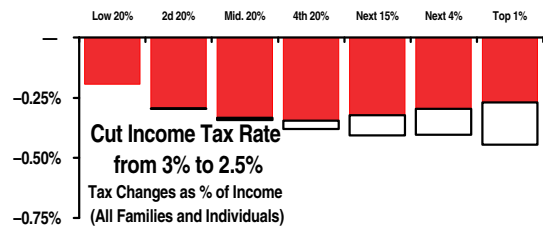
### Principal Features

- Cuts the state income tax rate from 3 percent to 2.5 percent.
- Reduces Illinois taxes by \$1.4 billion.
- Increases federal taxes by \$280 million.

### Discussion

This approach to tax reform is sometimes characterized as an across the board tax cut. After all, proponents argue, if the state's income tax rate is cut by 15 percent, then everyone should get the same tax break. The flaw in this argument is that the state personal income tax is only a portion of total state and local taxes—and the most progressive portion to boot. This means that a cut in the personal income tax while leaving other, more regressive, taxes untouched makes the tax system as a whole more regressive. If a 15 percent cut were proposed in *all* state taxes, such a cut would indeed be across the board and even-handed. It would also, of course, be tremendously expensive and would do nothing to reduce the regressivity of the current system.

While this option reduces state revenues by \$1.4 billion, only \$1.1 billion of this cut finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.



## 25. Exempt 100 percent of capital gains income from taxation

### Principal Features

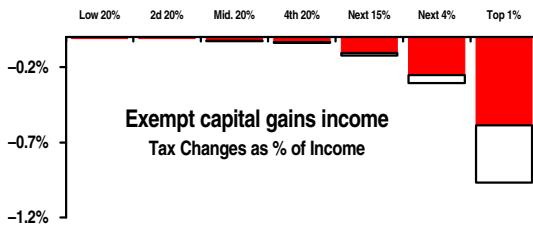
- Reduces Illinois taxes by \$1 billion.
- Tax cuts primarily to the wealthy.
- Increases federal taxes by \$330 million.

### Discussion

Capital gains tax cuts are often discussed as a means of encouraging economic growth through increased investment. Yet there is no clear evidence that capital gains tax cuts encourage growth even at the federal level. And capital gains exclusions are probably less effective as an approach to economic development when they are administered at the state level, since the additional investment (if any) encouraged by the capital gains exemption could take place anywhere in the United States or the world.

An equally important flaw of this approach to tax relief is that a substantial portion of this tax cut would flow not to the pockets of Illinoisans but to the federal government. The federal personal income taxes paid by Illinoisans would go up by \$330 million under this option because of the decrease in deductions for state personal income tax paid. While this option reduces state revenues by just over \$1 billion, only \$670 million of this cut—about two-thirds of the revenue loss to the state—finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.

In addition, the benefits of a capital gains tax cut are skewed toward the wealthiest Illinois taxpayers. The wealthiest one percent of Illinois taxpayers alone would receive 70 percent of the state tax cut from this option.



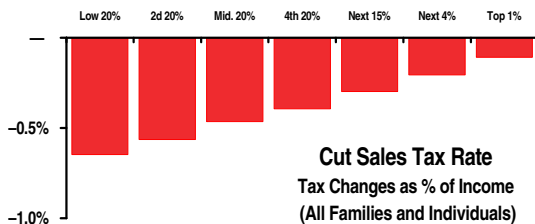
## 26. Sales Tax Rate Cut

### Principal Features

- Cuts statewide sales tax rate from 6.25 percent to 5.25 percent.
- Reduces Illinois taxes by \$1.3 billion.
- Progressive (but expensive) tax cut.

### Discussion

The Illinois state sales tax rate is one of the highest in the nation at 6.25 percent. This option provides progressive tax relief, reducing the state rate by 1 percent. (The tax rate on lower-rate items such as food and utilities is left unchanged.) Lower- and middle-income Illinoisans see a significantly greater tax cut as a share of income than do the wealthy. However, this approach would reduce state sales tax revenues by more than 15 percent. Because sales taxes are not deductible by federal itemizers, federal taxes paid by Illinois residents would not increase.



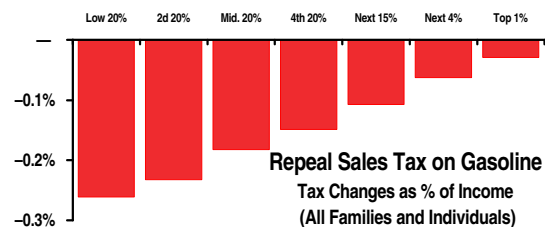
## 27. Permanent Elimination of Sales Tax on Gasoline

### Principal Features

- Eliminates gasoline from the state sales tax base.
- Reduces Illinois taxes by \$300 million.
- Progressive tax cut.
- Makes sales tax base more narrow.

## Discussion

Illinois is one of only nine states to tax gasoline with a separate excise tax while including sales of gasoline in the general sales tax base. This option would repeat, on a permanent basis, the temporary tax relief offered by the Illinois legislature in 2000. Because excise taxes are not deductible by federal itemizers, federal taxes paid by Illinois residents would be unchanged. When Illinois lawmakers enacted this tax break on a temporary basis in 2000, there was some public concern over the question of whether the tax cuts were actually being passed through to taxpayers: it is assumed here that taxpayers realize the full savings from the cut.



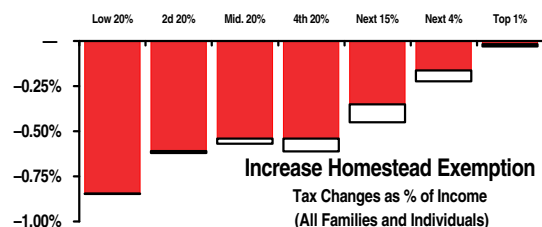
## 28. Increase Property Tax Homestead Exemption

### Principal Features

- Increases homestead exemption maximum from \$3,500 to \$10,000.
- Reduces Illinois taxes by \$1.375 billion.
- Progressive tax cut.
- Increases federal taxes by \$180 million.

### Discussion

Under current law, the Illinois homestead exemption provides property tax relief equal to the increase in the assessed value of a property over its 1977 assessed value, with a maximum of \$3,500. This option increases the maximum available homestead exemption from \$3,500 to \$10,000, and makes the exemption independent of the change in value since 1977. This exemption increase would





have a progressive effect on the Illinois tax burden, because exempting the first \$10,000 of home value would mean a 25 percent reduction in tax on a \$40,000 home, and a 10 percent reduction on a \$100,000 home. But because the homestead exemption is available to taxpayers at all income levels, close to \$200 million of the state tax cut would be offset by federal income tax increases.

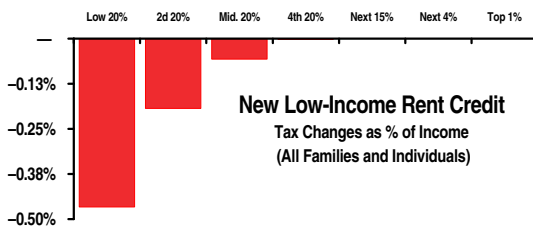
## 29. New Low-Income Renter Credit

### Principal Features

- Creates low-income property tax credit for renters.
- Credit capped at \$100 (\$200 for couples).
- Reduces Illinois taxes by \$120 million.

### Discussion

As discussed in Chapter Four, Illinois allows a property tax credit to those elderly and disabled homeowners and renters with incomes under \$28,000, but does not provide a similar credit to non-elderly renters. This option creates a \$100 non-refundable income tax credit against rental property taxes for taxpayers earning less than \$20,000 (\$40,000 for married couples). Because renters tend to be less wealthy, this is a progressive change.



## 30. Increase Property Tax Credit to 10 Percent

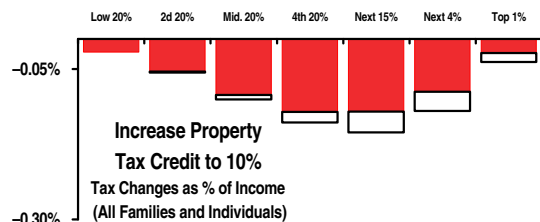
### Principal Features

- Doubles the income tax credit against property taxes from 5 percent of property taxes to 10 percent.
- Affects relatively few low-income taxpayers.
- Reduces Illinois taxes by \$370 million.
- Increases federal taxes by \$70 million.

### Discussion

Illinois currently allows all income-tax payers a nonrefundable income tax credit of five percent of homeowner property taxes paid. The progressivity of the credit is limited by its inapplicability to taxpayers who rent their homes or apartments, and by its nonrefundability. This would also be true of the proposal modeled here—it would not expand the number of taxpayers receiving the credit, but would simply increase the percentage of property taxes offset for those currently receiving the credit.

While this option reduces state revenues by \$370 million, only \$300 million of this cut finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.



# CONCLUSION

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This report has shown that chronic imbalances exist within the Illinois tax structure—and that sensible remedies exist for the structural flaws that limit the yield and progressivity of Illinois taxes.

In recent decades, lawmakers of all stripes have expressed interest in systematic tax reform. Yet, as this study has shown, the tax changes enacted in recent years have only perpetuated the balancing act that characterizes Illinois tax policy.

- Illinois has historically relied primarily on property taxes to fund elementary and secondary schools and other government functions. Yet while states across the nation have moved to reduce their reliance on these regressive property taxes through expansion of the income and sales tax base, Illinois has bucked this trend by further *increasing* its reliance on local property taxes as a revenue source. Meanwhile, the aggregate Illinois tax burden from the other traditional state and local revenue sources—personal income taxes and consumption taxes—remains below average.
- While Illinois lawmakers have enacted a series of mechanisms for property tax relief over the years, these tax credits and deductions are either expensive and poorly targeted (as is the case with the five percent property tax credit) or have lost much of their value for low-income taxpayers (as is true of the elderly circuit breaker and the homestead exemption).
- The Illinois income tax has historically been a low-yield tax because of its low, flat rate. Yet the provision of costly tax breaks for

pensions and Social Security income, and exclusions for property taxes paid and education expenses, has further depleted the yield of the tax. This narrow-base strategy has made it considerably more difficult for lawmakers to provide meaningful low-income tax relief. Recently enacted increases in the state’s personal exemption have been far from sufficient to offset the declining real value of the exemption. And while the state Earned Income Tax Credit offers important low-income tax relief, the non-refundability of the credit and its low 5 percent rate limits its usefulness to Illinois taxpayers.

- The Illinois sales tax base is among the narrowest in the nation, due to the almost complete exclusion of personal and professional services from the base, and due to costly partial exemptions for groceries and drugs. As a result, state and local governments must apply higher-than-average rates in order to obtain a sufficient stream of sales tax revenue.

These long-term imbalances in the Illinois revenue structure hurt low- and middle-income Illinoisans both directly, in the form of an oppressively high tax burden on the low-income taxpayers who are least able to afford it, and indirectly, by reducing the state’s ability to fund important government services in the long run.

As the state continues to grapple with these issues, we hope that this report will help lawmakers and the public achieve a better understanding of the options available for achieving greater balance in the Illinois tax system.

APPENDIX A: DETAILED DISTRIBUTIONAL TABLES

**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
<b>Sales, excise &amp; gross receipts taxes</b>	<b>7.4%</b>	<b>6.0%</b>	<b>4.8%</b>	<b>3.9%</b>	<b>2.9%</b>	<b>1.9%</b>	<b>1.0%</b>
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%
Sales, excise & gross receipts taxes, business	1.9%	1.5%	1.1%	0.9%	0.7%	0.5%	0.3%
<b>Property taxes</b>	<b>4.4%</b>	<b>3.5%</b>	<b>3.2%</b>	<b>3.3%</b>	<b>3.2%</b>	<b>2.8%</b>	<b>1.9%</b>
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%
<b>Income taxes</b>	<b>1.1%</b>	<b>1.7%</b>	<b>2.0%</b>	<b>2.2%</b>	<b>2.4%</b>	<b>2.5%</b>	<b>3.0%</b>
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%
<b>Total Before Federal Offset</b>	<b>13.0%</b>	<b>11.2%</b>	<b>10.0%</b>	<b>9.4%</b>	<b>8.5%</b>	<b>7.2%</b>	<b>6.0%</b>
Federal Itemized Deduction Offset	—	—	-0.1%	-0.4%	-1.0%	-1.1%	-1.1%
<b>Net after Federal Offset</b>	<b>13.0%</b>	<b>11.2%</b>	<b>9.9%</b>	<b>9.0%</b>	<b>7.6%</b>	<b>6.2%</b>	<b>4.9%</b>

**Illinois Taxes in 2000**  
**As Shares of Family Income for Married, Non-Elderly Taxpayers**

Income Range	Less than \$30,000	\$30,000 – \$60,000	\$60,000 – \$100,000	\$100,000 – \$200,000	\$200,000 or more
% of couples in group	10.3%	28.7%	34.0%	19.5%	7.0%
Average Income in Group	\$18,200	\$46,100	\$77,300	\$130,000	\$598,000
<b>Sales, excise &amp; gross receipts taxes</b>	<b>6.9%</b>	<b>4.6%</b>	<b>3.2%</b>	<b>2.2%</b>	<b>1.2%</b>
General sales tax, individuals	3.6%	2.6%	1.9%	1.3%	0.7%
Excise & gross receipts taxes, individuals	1.7%	1.0%	0.6%	0.4%	0.2%
Sales, excise & gross receipts taxes, business	1.6%	1.1%	0.7%	0.5%	0.3%
<b>Property taxes</b>	<b>5.9%</b>	<b>3.3%</b>	<b>3.1%</b>	<b>3.1%</b>	<b>2.1%</b>
Property taxes on families	5.6%	3.0%	2.8%	2.7%	1.1%
Business property taxes	0.3%	0.3%	0.3%	0.4%	1.0%
<b>Income taxes</b>	<b>1.1%</b>	<b>2.1%</b>	<b>2.4%</b>	<b>2.5%</b>	<b>2.9%</b>
Personal income tax	1.1%	2.1%	2.4%	2.4%	2.6%
Corporate income tax	0.1%	0.1%	0.1%	0.1%	0.3%
<b>Total Before Federal Offset</b>	<b>13.9%</b>	<b>10.1%</b>	<b>8.8%</b>	<b>7.9%</b>	<b>6.2%</b>
Federal Itemized Deduction Offset	0.1%	-0.2%	-0.8%	-1.2%	-1.2%
<b>Net after Federal Offset</b>	<b>14.0%</b>	<b>9.9%</b>	<b>8.0%</b>	<b>6.7%</b>	<b>5.0%</b>

## Illinois Taxes in 2000

### As Shares of Income for Unmarried, Non-Elderly Taxpayers

Income Range	Less than \$15,000	\$15,000 – \$30,000	\$30,000 – \$50,000	\$50,000 – \$100,000	\$100,000 or more
% of taxpayers in group	30.9%	32.0%	23.2%	10.6%	1.7%
Average Income in Group	\$8,450	\$22,330	\$38,280	\$64,000	\$196,000
<b>Sales, excise &amp; gross receipts taxes</b>	<b>7.3%</b>	<b>5.4%</b>	<b>3.9%</b>	<b>2.8%</b>	<b>1.3%</b>
General sales tax, individuals	3.4%	2.8%	2.1%	1.6%	0.8%
Excise & gross receipts taxes, individuals	2.1%	1.3%	0.8%	0.6%	0.2%
Sales, excise & gross receipts taxes, business	1.8%	1.3%	0.9%	0.7%	0.3%
<b>Property taxes</b>	<b>3.2%</b>	<b>2.1%</b>	<b>2.3%</b>	<b>2.5%</b>	<b>2.2%</b>
Property taxes on families	3.0%	1.8%	2.0%	2.1%	1.3%
Business property taxes	0.2%	0.3%	0.3%	0.4%	0.9%
<b>Income taxes</b>	<b>1.4%</b>	<b>2.2%</b>	<b>2.5%</b>	<b>2.5%</b>	<b>2.7%</b>
Personal income tax	1.4%	2.2%	2.5%	2.4%	2.4%
Corporate income tax	0.0%	0.0%	0.0%	0.1%	0.3%
<b>Total Before Federal Offset</b>	<b>11.9%</b>	<b>9.7%</b>	<b>8.7%</b>	<b>7.8%</b>	<b>6.1%</b>
Federal Itemized Deduction Offset	0.0%	0.0%	-0.2%	-0.6%	-0.9%
<b>Net after Federal Offset</b>	<b>11.9%</b>	<b>9.7%</b>	<b>8.5%</b>	<b>7.1%</b>	<b>5.3%</b>

## Illinois Taxes in 2000

### As Shares of Family Income for Elderly Taxpayers

Income Range	Less than \$15,000	\$15,000 – \$30,000	\$30,000 – \$50,000	\$50,000 – \$100,000	\$100,000 or more
% of taxpayers in group	22.2%	27.9%	20.4%	19.1%	10.0%
Average Income in Group	\$9,600	\$21,700	\$38,400	\$68,900	\$307,000
<b>Sales, excise &amp; gross receipts taxes</b>	<b>7.0%</b>	<b>5.3%</b>	<b>4.1%</b>	<b>2.7%</b>	<b>1.3%</b>
General sales tax, individuals	3.3%	2.7%	2.2%	1.5%	0.8%
Excise & gross receipts taxes, individuals	1.9%	1.2%	0.9%	0.5%	0.2%
Sales, excise & gross receipts taxes, business	1.8%	1.3%	1.0%	0.7%	0.4%
<b>Property taxes</b>	<b>6.7%</b>	<b>7.6%</b>	<b>5.7%</b>	<b>5.3%</b>	<b>3.0%</b>
Property taxes on families	6.3%	6.8%	4.7%	4.1%	1.4%
Business property taxes	0.4%	0.8%	1.0%	1.2%	1.6%
<b>Income taxes</b>	<b>0.2%</b>	<b>0.6%</b>	<b>0.8%</b>	<b>1.3%</b>	<b>2.7%</b>
Personal income tax	0.1%	0.3%	0.5%	0.9%	2.1%
Corporate income tax	0.1%	0.3%	0.3%	0.4%	0.5%
<b>Total Before Federal Offset</b>	<b>13.9%</b>	<b>13.5%</b>	<b>10.5%</b>	<b>9.4%</b>	<b>7.0%</b>
Federal Itemized Deduction Offset	0.0%	-0.0%	-0.1%	-0.2%	-0.8%
<b>Net after Federal Offset</b>	<b>13.9%</b>	<b>13.4%</b>	<b>10.5%</b>	<b>9.1%</b>	<b>6.2%</b>

## APPENDIX B: ITEP TAX MODEL METHODOLOGY

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

**The Personal Income Tax Model** analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

**The Consumption Tax Model** analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence

implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

**The Property Tax Model** analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

**The Corporate Income Tax Model** analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

**Local taxes:** The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

### Addendum: Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

#### *Micro-Data Sets:*

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

#### *Partial List of Aggregated Data Sources:*

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP internet site at [www.itepnet.org](http://www.itepnet.org).