Institute on Taxation and Economic Policy
Testimony of Kelly Davis
Regarding House Bill 750
March 20, 2007

Thank you Chairwoman Soto and members of the Committee for the opportunity to appear today. My name is Kelly Davis. I am here representing the Midwest Office of the Institute on Taxation and Economic Policy (ITEP). Using a microsimulation tax model, ITEP's research focuses on federal and state tax policy issues, especially as they affect low- and middle-income taxpayers. A description of ITEP's microsimulation tax model can be found in the attached Appendix.

My testimony today focuses on the revenue-raising tax reform bill, House Bill 750 and Illinois' current tax structure. In particular, my testimony will discuss the state's current tax structure and reveal the opportunity that HB 750 provides.

The Equity of Illinois' Current Tax Structure

Illinois' tax system is regressive. In 2004, on average, the bottom 20 percent of Illinois households paid 12.8 percent of their income in state and local taxes while the top 1 percent only paid 4.6 percent (after taking federal deductions for state and local taxes into account). The regressiveness of Illinois' tax structure is attributable to the state's sales and excise taxes and heavy reliance on property taxes.

The most regressive aspect of Illinois' tax system are sales and excise taxes. For 2004:

- The poorest Illinoisans — those earning less than $16,000 — paid 7.8 percent of their income in sales and excise taxes.
- Illinoisans in the middle of the income distribution paid an average of 4.7 percent of their income in these taxes.
- The wealthiest one percent of Illinois taxpayers paid an effective sales and excise tax rate of 1 percent.

Put another way, the Illinois consumption tax structure is equivalent to an income tax with a 7.8 percent rate for the poor, a 4.7 percent rate for the middle class, and a 1 percent rate for the wealthiest Illinois taxpayers.

Furthermore, Illinois' sales tax base is among the narrowest in the nation due to the exclusion of many goods and services. As a result, a higher tax rate must be applied in order to generate a sufficient amount of revenue. Additionally, Illinois' recent proliferation of local sales taxes has made the system even more regressive without addressing the underlying narrow base problem. Specific exemptions on select items favor certain businesses at the expense of others which in turn harms Illinois' business competitiveness. For example, sales tax exemptions for manufacturing machinery discriminates against service provider businesses that do not have a need for such capital investment. Additionally, the closer Illinois' sales tax base reflects consumer realities, the more it will naturally grow with the economy — a serious consideration given Illinois' current structural deficit problem.

Broadening the sales tax base will not eliminate its regressive impact. However, the creation of a refundable family size credit, as proposed in HB 750, would help alleviate the sales and excise tax burden for low- and middle- income Illinois households. Our previous analysis of this proposal showed that, on average, this credit would completely compensate low- and middle-income taxpayers for the base broadening measures proposed in HB 750.

While Illinois taxes are below the national average overall, Illinois property taxes are among the highest in the nation. Whereas other states have shifted from a historical reliance on local property taxes toward state- level sources, Illinois has increased its reliance on local property taxes as a revenue source. As a share of total revenue, property taxes constituted 35 percent in 1979, increasing to 39.6 percent by 2004. Illinois continues to rely heavily on property taxes to fund schools, this creates large inequities in the quality of education between schoolchildren living in low-wealth and high-wealth school districts.

Property taxes are regressive. And because these taxes are based on home values rather than income, property taxes are not sensitive to a homeowner's ability to pay the tax.

Property taxes are especially burdensome for fixed-income taxpayers who are "property rich" but "income poor." Distributionally in 2004, the bottom 20 percent of Illinoisans paid 3.8 percent of their income in property taxes, on average. The top 1 percent of Illinois taxpayers paid 1.7 percent of their income in property taxes, on average.

Twp progressive components of Illinois' tax structure are the personal and corporate income taxes. In 2004, the bottom 20 percent of households paid, on average, 1.2 percent of their income in these taxes while the top 1 percent of Illinoisans paid 3.1 percent of their income in these taxes, on average.

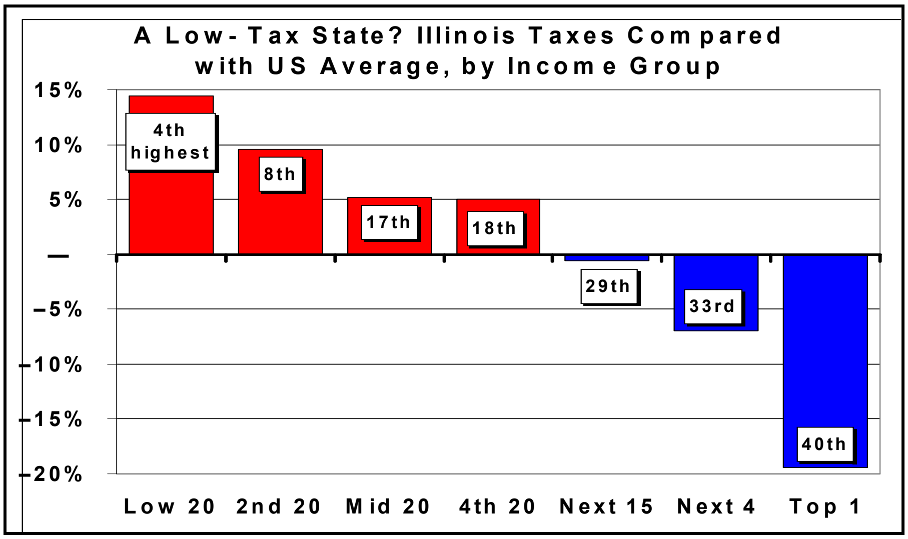
For your convenience, the attached table and chart show the incidence of Illinois' state and local tax system for 2004, including the amount of benefits received for those who itemize state and local taxes on their federal income taxes.

How High are Illinois Taxes?

ITEP's *Who Pays* analysis of tax structures in all fifty states showed that while Illinois taxes are below average overall, many low- and moderate-income Illinoisans are treated much more harshly. The chart below shows how Illinois taxes stack up for each income group in 2000:

- While Illinois taxes overall are slightly below the national average, the taxes paid by the poorest 20 percent of Illinoisans ranked fourth highest in the nation—almost 15 percent above the U.S. average.
- The taxes paid by middle-income Illinoisans were 17th highest in the nation, 5 percent above the national average.
- At the other end of the income spectrum, the taxes paid by the wealthiest 1 percent of Illinoisans were just 40th highest, almost 20 percent below the national average.
- Overall, the poorest 80 percent of Illinois families actually faced tax liabilities above the national average—while the wealthiest 20 percent paid taxes well *below* the national average.

In other words, the answer to the question of how Illinois taxes stack up differs radically for taxpayers at different income levels. Illinois is both a very low-tax state (for the wealthiest Illinoisans) and a very high-tax state (for the poorest Illinois residents).

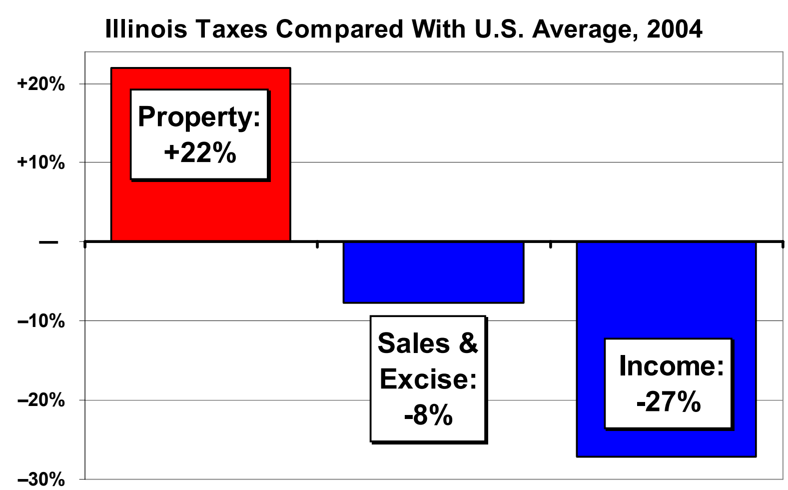


The Imbalance of Illinois' Current Tax Structure

Illinois state and local taxes are slightly below the national average overall—but some Illinois taxes are especially low, while others are especially high.

- In 2004, Illinois taxes overall were 10.4 percent of statewide personal income, slightly below the nationwide average.
- Illinois personal income taxes were more than 27 percent below the national average.
- Illinois property taxes were 22 percent above the national average.

This over-reliance on the property tax and under-reliance on the income tax indicates a fundamental imbalance in the Illinois tax structure—an imbalance that has been remedied in most other states.



Specific aspects of HB 750:

- Increasing the personal income tax rate from 3 percent to 5 percent;
- Increasing the corporate income tax rate from 4.8 percent to 8 percent;
- Broadening the sales tax base to include items such as consumer and recreation services;
- Introducing a refundable sales tax credit; and
- Reducing property taxes across the board.

Our previous analysis of an earlier version of House Bill 750 showed that if the legislation were implemented in 2002, aggregate tax revenue collections would have increased by approximately $3.8 billion. The change in the combined federal and state income taxes actually paid by Illinois taxpayers, however, would have been smaller—approximately $3 billion. This is because the state tax hike in HB 750 would have resulted in a federal tax *cut* of over $800 million for Illinois residents who itemize on their federal income taxes.

The overall distribution of HB 750 would be progressive. The bottom 60 percent of Illinois taxpayers would be held harmless, on average. The top 40 percent of Illinois taxpayers would see a state tax increase equivalent to a little more than 1 percent of their incomes, on average.

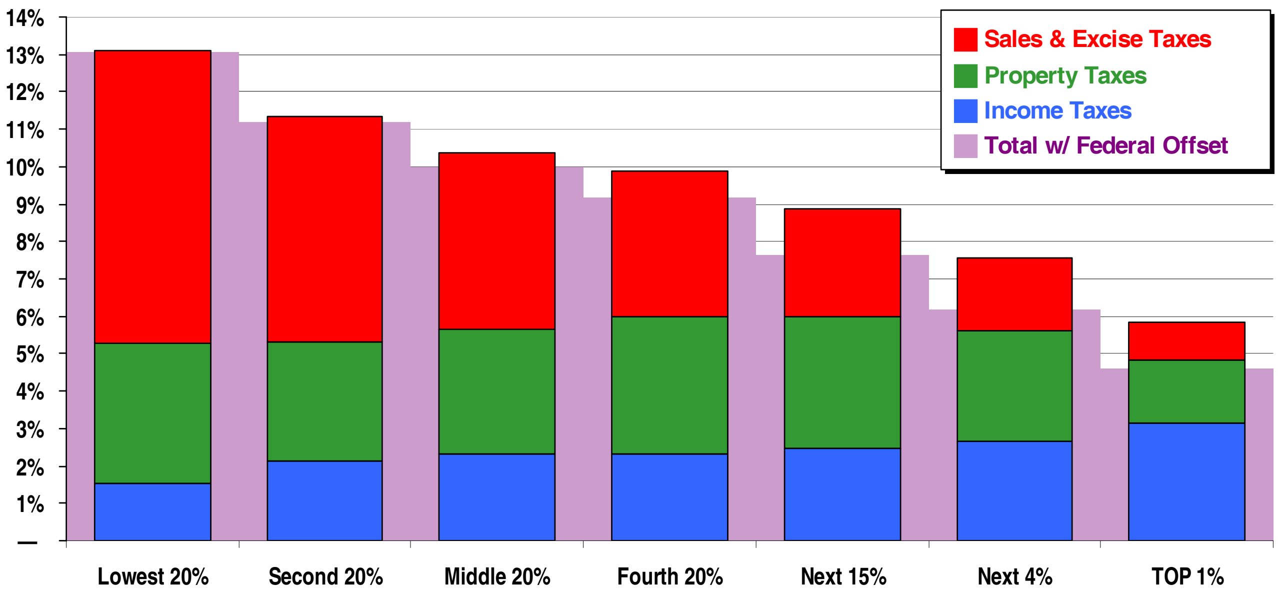
Conclusion

ITEP's previous analysis of HB 750 shows that it would raise approximately $3.8 billion a year to fund public services while reducing taxes on many low- and middle- income Illinoisans, and make Illinois' tax system more equitable. Shifting revenue sources away from property taxes, broadening the sales tax in conjunction with a refundable sales tax credit, and increasing income taxes will make Illinois' tax structure more responsive to a taxpayer's ability to pay and hence more progressive.

By closely connecting taxes collected to income and broadening the sales tax base, HB 750 will ensure that state revenues are more sustainable over time and grow more in sync with the economy. Thank you for the opportunity to testify.

Illinois State and Local Taxes in 2004

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: TOP 1%
Income Range	Less than $16,000	$16,000 – $30,000	$30,000 – $48,000	$48,000 – $77,000	$77,000 – $148,000	$148,000 – $295,000	$295,000 or more
Average Income in Group	$8,900	$22,600	$38,500	$61,100	$101,400	$203,600	$1,322,100
Sales & Excise Taxes	**7.8%**	**6.0%**	**4.7%**	**3.9%**	**2.9%**	**1.9%**	**1.0%**
General Sales—Individuals	3.5%	3.1%	2.6%	2.2%	1.7%	1.2%	0.6%
Other Sales & Excise—Ind.	2.3%	1.4%	1.0%	0.7%	0.5%	0.3%	0.1%
Sales & Excise on Business	1.9%	1.6%	1.2%	1.0%	0.7%	0.5%	0.3%
Property Taxes	**3.8%**	**3.2%**	**3.3%**	**3.7%**	**3.5%**	**3.0%**	**1.7%**
Property Taxes on Families	3.6%	3.0%	3.1%	3.4%	3.2%	2.5%	0.8%
Other Property Taxes	0.2%	0.2%	0.2%	0.2%	0.3%	0.5%	0.9%
Income Taxes	**1.2%**	**2.0%**	**2.3%**	**2.3%**	**2.5%**	**2.7%**	**3.1%**
Personal Income Tax	1.2%	1.9%	2.2%	2.3%	2.4%	2.5%	2.6%
Corporate Income Tax	0.0%	0.0%	0.1%	0.1%	0.1%	0.2%	0.5%
TOTAL TAXES	**12.8%**	**11.2%**	**10.4%**	**9.9%**	**8.9%**	**7.6%**	**5.8%**
Federal Deduction Offset	–0.0%	–0.2%	–0.4%	–0.7%	–1.2%	–1.4%	–1.2%

Appendix: About ITEP and the ITEP Tax Model

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records (including 27,520 records for Illinois). This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record—by—record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2003, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study was released jointly with Citizens for Tax Justice. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty—state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. Recent major foundation—funded state studies include) *Tax Strategies for a Strong Minnesota* (1998) and *Choices for Iowa: Building A Better Tax System* (1998) and *Balancing Act Tax Reform Options For Illinois* (2002).