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Revenue Options for Illinois

Income Tax

A. Increase the Individual Income Tax: Enhancing the state's income tax has the most revenue generating potential of all available alternatives. It also is one of the most appropriate revenue sources to be used, for a number of reasons. Illinois' maximum combined state and local income tax rate is the lowest in the country and the state's overall tax burden ranks 48th when all state and local taxes, charges and user fees are considered. Moreover, state income taxes can be deducted from federal income tax obligations. Finally, because the tax is based on income, a taxpayer's individual burden will correspond to his or her means, increasing or decreasing with the taxpayer's income.

Table 1: Individual Income Tax Options[1]

Rate	Additional Revenue Generated ($ in millions)	Local Governments[2]	Net to State
3.5%	$1,400	$140	$1,260
4.0%	$2,830	$283	$2,547
4.5%	$4,300	$430	$3,870
5.0%	$5,660	$566	$5,094

B. Increase the Corporate Income tax rate: Under the constitution, the Illinois Corporate Income Tax can be no more than 8/5 of the personal income tax. Increasing the Individual Income Tax to 4.0% means the Corporate Income Tax could be no more than 6.4 percent. Increasing the Individual Income Tax to 5.0% means the Corporate Income Tax could be no more than 8.0 percent.

Table 2: Corporate Income Tax Options[3]

Rate	Additional Revenue Generated ($ in millions)	Local Governments	Net to State
6.4%	$475	$48	$428
8.0%	$950	$95	$855

[1] Calculations based on actual Fiscal Year 2006 Individual Income Tax receipts data from the Illinois Commission on Government Forecasting and Accountability.
[2] Local Governments receive 1/10 of net Individual and Corporate Income taxes.
[3] Calculations based on actual Fiscal Year 2006 Corporate Income Tax receipts data from the Illinois Commission on Government Forecasting and Accountability.

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Sales Tax

Expanding the current Illinois Sales Tax base to include consumer services (not business, health care or housing services) at the current state rate of 5.0% would generate approximately $1.7 billion in new revenue. Options for both the expansion of the base to include consumer services with a reduction in the sales tax rate would generate:

Table 3:
Total State Revenue Generated by Including Consumer Services in the Illinois Sales Tax Base by Rate Option[4]

Rate	Additional Revenue Generated ($ in millions)
3.0%	$-1,810
3.5%	$-937
4.0%	$-57
4.5%	$822
5.0%	$1,700

Closing Corporate Tax Loopholes: $826.4 - $846.4 million[5]

1. **Repeal the Single Sales Factor - $96 million.** Illinois changed its method for determining the corporate income tax, from a three-part formula to the single sales factor. Under the single sales factor, corporate income taxable in Illinois is determined solely on the basis of a company's in-state sales. Under the prior method, in addition to sales, the value of a corporation's property and payroll in Illinois were considered. Under the single sales factor, large, multinational companies who have a strong presence (facilities and employees) in Illinois, and are therefore the largest beneficiaries of state services, receive major income tax cuts. Small mom and pop shops, who principally make all their sales in the state, receive no benefit. According to a report issued by then Illinois Comptroller, Republican Loleta A. Didrickson, 32 companies were projected to gain at least $1 million per year in tax savings. The result, a net tax revenue loss to the state and local governments that the Illinois Department of Revenue estimated reached **$96 million** in FY 2001 ($63M state and $33M local) (This is the last year the Department of Revenue analyzed the loss to the state).

2. **Reduce the Retailers Discount**. The Retailers Discount was enacted in 1959 to reimburse businesses for the burden of computing and collecting the state sales tax that applied to their sales. Under the statute, retailers keep 1.75% of the sales tax they collect. While this discount served a legitimate purpose in 1959, its value is questionable today. With computerized collection and accounting systems prevalent, the cost of collecting sales taxes, especially for large retailers, is built into software packages and is negligible. Twenty-four states do not provide any discounts for sales tax collection. Of the 26 that still have these outmoded discounts, 10 have capped the maximum discount. Capping the Illinois discount at 1.75% of the first $1 million in sales is a practical solution. This preserves the discount for small businesses while greatly reducing the cost of this tax expenditure. This sensible change will save **$80-100 million** annually.

3. **Eliminate public subsidies to the horse racing industry:** Illinois currently gives this horse racing industry millions in tax breaks. Elimination of breaks would generate **$48 million**.

[4] Calculations based on actual Fiscal Year 2006 Illinois Sales Tax receipts data from the Illinois Commission on Government Forecasting and Accountability.
[5] Calculations based on Illinois Comptroller, Tax Expenditure Report, 2005.

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Other Corporate Tax Loopholes

- Newsprint and Ink to Newspapers and Magazines Exemption: **$41 million**
- Manufacturing and Assembling Machinery and Equip Exemption: **$164 million**
- Sales of Vehicles to Automobile Rentors Exemption: **$43 million**
- Enterprise and Foreign Trade Zone Dividend Subtractions: **$2.4 million**
- Enterprise and Foreign Trade Zone High Economic Impact Business Exemption: **$37 million**
- Timely Filing and Full Payment Discount: **$28 million**
- Trade-in allowance: **$20 million**
- Real Estate Investment Trusts – For tax years ending on or after Dec 31, 2008**: $40 million**
- Redefining "business income" to include all income apportionable to Illinois by the U.S. Constitution: **$29 million**
- Sales sourcing rules – for corporate income tax –
  - replace cost of performance rule with market state approach for service industries**: $40 million**
  - special industry rules (financial organizations/transit companies): **$60 million**
- Eliminate tax benefit of related party transactions (dividends from subsidiaries with no business substance/insurance premiums paid to capture insurance companies): **$40 million**
- Discharge of debt**: $4 million**
- Expense disallowance for exempt securities income**: $25 million**
- Withholding on non-resident partners/subchapter S shareholders**: $4 millions**
- Corporate Franchise Tax Amnesty**: $25 million**

Table 4:
Revenue Estimates - SB 1544[6]

	$ in millions
Corporate Franchise Tax Amnesty	$25
Withholding on non-resident partners/subchapter S shareholders	$4
Expense disallowance for exempt securities income	$25
Discharge of debt	$4
Eliminate tax benefit of related party transactions (dividends from subsidiaries with no business substance/insurance premiums paid to capture insurance companies	$40
Replace cost of performance rule with market state approach for service industries	$40
Special industry rules (financial organizations/transit companies)	$60
Redefining "business income" to include all income apportionable to Illinois by the U.S. Constitution	$29
Real Estate Investment Trusts – For tax years ending on or after Dec 31, 2008	$40
Exemption: Sale of Vehicles to auto rentors	$24
TOTAL	**$291**

Closing Personal Tax Loopholes: $670 - $715 million[7]

1. **Create a means test for the Illinois tuition tax credit:** There currently is no income limit on the Illinois tuition tax credit. As a result, relatively affluent taxpayers have received by far the most benefits from this tax break. Taxpayers with incomes of $50,000 or more per year accounted for 77% of the tax relief in 2004. Taxpayers with incomes of $100,000 or more accounted for almost 40% of the credit. Limiting the credit to families earning $60,000 a year or less would preserve the credit for low- and moderate-income families while saving the state **$40-$45 million** annually.

[6] Based on Illinois House Democrats SB 1544 Fact Sheet.
[7] Calculations based on Illinois Comptroller, Tax Expenditure Report, 2005.

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2. **Subject pension income earned over $75,000 to taxation:** Illinois is one of only three states that exempts all pension income from taxation. Low- and moderate-income seniors work to make ends meet, and subsequently pay taxes on their wages. Affluent seniors, on the other hand, do not have to work and also avoid paying taxes on their pensions. Exclusion of all pension income costs the state over $800 million annually in new revenue. Subjecting pension income over $75,000 to taxation would generate **$200 million** in new revenue annually.

3. **Eliminate or means-test the Property Tax Credit:** The Property Tax Credit costs the state of Illinois over $400 million a year. The credit primarily benefits wealthy homeowners, as only 20% of individuals earning $25,000 a year or less own a home. Creation of a means-test for this tax credit would preserve the benefit for low- and middle-income families while saving the state an estimated **$200-$240 million** annually.

4. **Coordination of credits/exemptions:** Multiple forms of tax credits/exemptions could duplicate policy purposes. Consolidating all of them into one credit/exemption could eliminate duplication and produce more targeted benefits. This could generate up to **$200 million.**

Gaming

Industry analysts project that adjusted gross receipts for wagering at Illinois riverboat casinos will continue to increase for the foreseeable future. In light of the windfall profits accruing to riverboat casino operators in Illinois, the very low cost of obtaining licenses for riverboat casinos in the state, as well as the social costs associated with gambling, the industry seems to be an appropriate one to pay increased taxes.

The Center for Tax and Budget Accountability proposes **increasing the marginal tax rates** for the gambling industry as follows:

* 25% of adjusted gross receipts up to and including $25 million;
* 30% of adjusted gross receipts in excess of $25 million but not exceeding $50 million;
* 35% of adjusted gross receipts in excess of $50 million but not exceeding $75 million;
* 40% of adjusted gross receipts in excess of $75 million but not exceeding $100 million; and
* 45% of adjusted gross receipts in excess of $100 million but not exceeding $200 million; and
* 52.5% of adjusted gross receipts in excess of $200 million

Based on data from the Illinois Gaming Board 2006 Annual Report, increasing the marginal tax rates applicable to casino gambling in Illinois in accordance with the preceding tables would generate an additional **$150 million annually** in revenue.

Existing Proposal: Revenue estimate is $1.5 to $2.0 billion (However, testimony by Economics Professor, Dr. Victor Mathason to the Commission on Government Forecasting and Accountability puts the number much lower, somewhere between $260 and $500 million).[8]

Expansion of the number of positions at existing riverboat casinos from 1,200 to 2,000
Allow a land based Chicago casino with 4,000 positions
Allow three other Chicago area casinos with 3,500 positions each

[8] Testimony of Dr. Victor Matheson Department of Economics, College of the Holy Cross May 5, 2005 for the Illinois Commission on Government Forecasting and Accountability.

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Carbon Emissions Charge - $2 billion

Creating "cap and trade" system on carbon emissions similar to the one used in the Clear Air Act of 1990 in Illinois could generate about **$2 billion annually.**[9] Additionally, it would decrease carbon emissions over time and generate dollars that could be devoted to energy efficient technologies. Because most of the cost to business would be passed on to consumers, it should be coupled with targeted relief to low and middle income families to eliminate potential regressive impacts.

Federal Decoupling
Qualified Production Activities Income (QPAI) - $89-$130 million

- The federal corporate income tax break known as the "qualified production activities income," or QPAI, deduction, costs Illinois between $89 million and $130 million in tax revenue annually.[10]

- Because Illinois uses "federal taxable income" as the starting point for calculating the state corporate income tax, new federal tax breaks like the QPAI result in decreased state income tax revenue unless Illinois "decouples" from the federal income tax provision. To decouple from a specific federal tax rule, Illinois must enact a state law providing that it will not follow the federal provision.

- The federally enacted American Jobs Creation Act of 2004 created the QPAI deduction, which provides corporations a deduction for federal income tax purposes for certain domestic production activities. The deduction, however, includes a broader range of manufacturing activities than originally intended, including architectural and engineering services, home and building construction, filmmaking and coffee-roasting activities.

- The QPAI deduction was originally intended to replace a corporate income tax exclusion (the "extraterritorial income exclusion" or ETI) that was repealed because it violated international law. However, the QPAI deduction became a new avenue for corporate income tax breaks, not only replacing the tax benefit lost by the repeal of the ETI, but effectively granting a significant tax cut with the corporate income tax deduction. According to the Center on Budget and Policy Priorities, the QPAI deduction is one of the largest corporate tax breaks enacted in recent years. The Joint Committee on Taxation estimates that the deduction will cost the federal government $10.7 billion annually when fully phased in.

- Under increasing fiscal pressure, most states simply cannot afford the lost state tax revenue that results if the federal QPAI deduction is granted to corporations for state income tax purposes. Illinois is no exception. Moreover, there is no economic reason states should allow the QPAI deduction. The tax break does not protect or create state jobs and can be claimed for out-of-state production activities. Nineteen states have already, or are likely to, decouple from the federal QPAI deduction.

- Facing severe annual revenue shortfalls, Illinois cannot afford the federal QPAI corporate income tax break. For fiscal year 2005 alone, the Illinois State Comptroller reported a budget deficit of over $3 billion. Moreover, state budget deficits are only expected to continue until Illinois addresses the structural problems in its fiscal system. Accordingly, Illinois does not have the luxury of granting unnecessary tax breaks, which result in decreased tax revenue and provide no economic benefit to state. Therefore, Illinois should decouple from the QPAI federal income tax deduction.

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[9] Center for Tax and Budget Accountability calculation based on the emissions of CO2 annually by Illinois' emitters and the minimum auction priced established in the statute.

[10] Revenue figure based on Center for Budget and Policy Priorities, *Sates are Decoupling from the Federal QPAI Deduction*, Sept., 2005.

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Sale of the Illinois Lottery

Leasing the Illinois lottery would generate an estimate **$10 billion** to use toward paying down the state retirement pension unfunded liability. However, if the lottery is leased, a separate revenue stream must be introduced to replace the annual revenue stream that is targeted to education from lottery proceeds. For FY 2008, education is forecasted to receive $650 million from the lottery. In addition to funding education, the lottery currently provides revenue for other "specialty causes." The FY 2008 transfer to these "specialty causes" like breast cancer funding, is $4 million**. If the lottery is leased, the state will have to replace that shortfall in General Revenue Fund (GRF) or cut other programs.**

If the state received $10 billion in sale of lottery proceeds it would reduce the unfunded liability to $30.7 billion. This could save the state an estimated $21 billion over the next 40 years. However, it is important to restate the state would have to find another source of revenue to fill the hole the GRF would have received from lottery proceeds.

Sale of Pension Obligation Bonds (POB)

Illinois could save money long-term by issuing pension obligation bonds to refinance existing pension debt for one simple reason, lower interest rates. The current interest rate of 8.0% to 8.5% on the unfunded pension liability is higher than interest rates available in the bond market.

How a POB Works

The state would issue a $16 billion pension obligation bond at an interest rate lower than 8.0% and then deposit the proceeds immediately into the pension fund to pay off all or some of the current unfunded liability.

If structured appropriately, the state would save money because the interest rate paid on the bond debt will be less than the interest rate on the unfunded liability.

For example, the state is currently paying an 8.0% to 8.5% interest rate on the unfunded liability. If the POBs are issued at a 6.0% interest rate, the 2.0% to 2.5% differential is the savings to the state.

A POB reduces but ***does not eliminate*** the state's $40.7 billion unfunded liability. There are also bond issuance costs, such as lenders fees, bond counsel fees and other miscellaneous fees. However, unlike current practices, once the state issues a POB it would have the fiscal discipline imposed on it to pay the bonds, because of the legal and contractual obligations owed to the bond holders.

Finally, while issuing pension obligation bonds could both save money and create fiscal discipline, the option is not truly viable unless Illinois raises enough in new tax revenue to meet both its debt service obligation and maintain essential services.

Using a simple interest formula, at the least, the state would save an estimated $14 billion over the next 40 years by issuing $16 billion in pension obligations bonds at 6.0 percent. Depending on the bond terms, the state could save more.

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Gross Receipts Tax

For FY 2008, the state is proposing the passage of a new tax on business called the Gross Receipts Tax or GRT. A GRT is a tax imposed on *all income received by a business* without any deductions for costs of doing business, such as a deduction for wages. GRTs are not based on a company's profit, or loss for a given tax year like the current Illinois Corporate Income Tax; rather, they are owed on all income, regardless of whether or not business is profitable. This makes the GRT a stable revenue source because all firms, even unprofitable ones, pay some tax, which results in more revenue for the state.

The Illinois proposed GRT is a tax of 0.85% on all manufacturing goods and 1.95% on all service industry items. Business with receipts under $2 million would be exempt from the GRT. The tax is estimated to raise $2.186 billion in FY 2008 and after that annually around $7.6 billion.[11] Additionally, the state has proposed a 3.0% payroll tax that all employers with ten or more workers would pay on Illinois employee wages. This payroll tax would be reduced by a credit based upon the employer's contribution to cover health insurance cost for his/her employees. The tax is expected to generate $1.3 billion.[12]

Value Added Tax on Corporations

A value-added tax (VAT) is a fee that is assessed against businesses by a government at various points in the production of goods or services—usually any time a product is resold or value is added to it. For tax purposes, value is added whenever the value of a product increases as a result of the application of a company's factors of production, such as labor and equipment. VAT must be paid by every company that handles a product during its transition from raw materials to finished goods. For example, tax is charged when a manufacturer sells to a wholesaler and again when a wholesaler sells to a retailer.

With VAT, the taxable amount is based on the value added at each stage of the process of producing goods and bringing them to market. As an example, say that a company that makes socks buys cotton yarn for $1,000; adds $500 to its value in terms of labor, depreciation of knitting machines, and profits; then sells the completed socks for $1,500. VAT would be calculated as a percentage of the $500 value added by turning cotton yarn into socks. Of course, the sock company would also get credit for the amount of VAT it paid on the purchase of inputs, like cotton yarn.

William G. Gale of the Brookings Institution and C. Eugene Steuerle of the Urban Institute estimate that nationally, each percentage point of a VAT with only a few exclusions could generate net revenue equivalent to 0.4% of the national gross domestic product (GDP). For calendar year 2005, U.S. gross domestic product was $12.5 trillion. For calendar year 2005, each 1.0% rate for a VAT could have raised net revenue of approximately $50 billion with a broad base. Thus, for 2005, according to the Gale/Steuerle estimate, a U.S. VAT of 5% would have generated $250 billion in revenue.

Using the same methodology, implementing a 1% VAT in Illinois would generate approximately $2.24 billion in revenue. This calculation is based on 0.4% of the 2005 Illinois Gross State Product, which was $560,236 billion.[13]

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[11] Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast, March 2007.
[12] Illinois Office of Management and Budget, Fiscal Year 2008 Budget Book.
[13] United States Bureau of Economic Analysis.

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