CTBA | Center for Tax and Budget Accountability

Issue Brief

WHY TAXATION IN ILLINOIS IS UNFAIR

January 2008

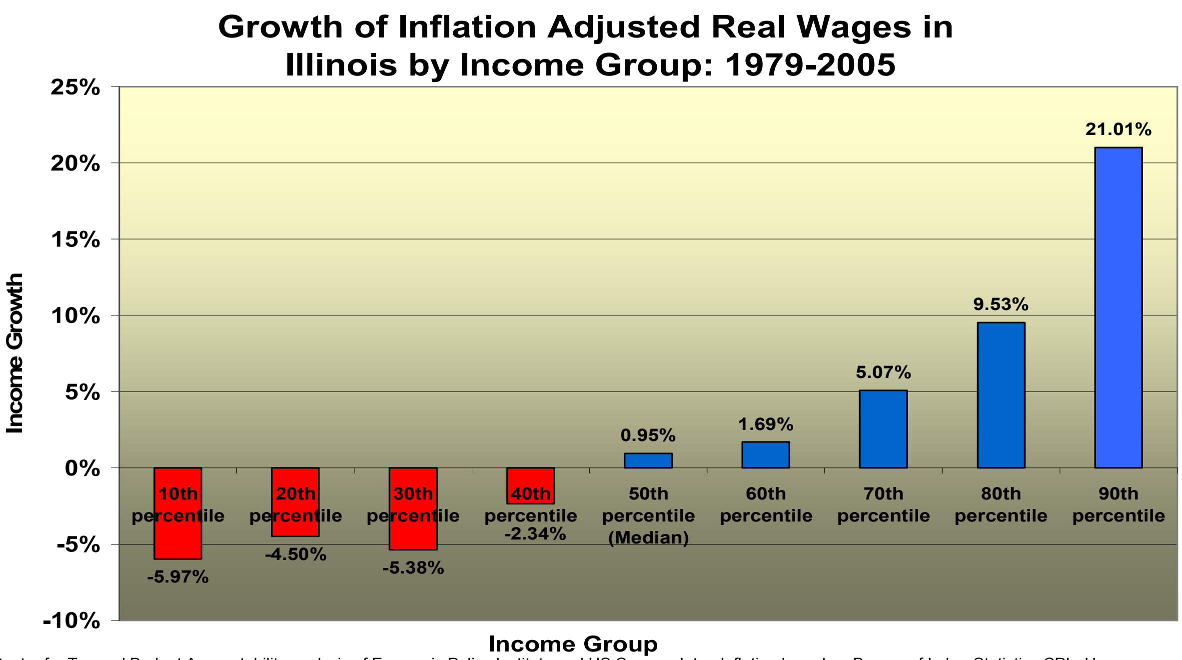
Defining Fairness.

Tax policy is by its nature a contentious subject. In the end, individuals pay different proportions of their incomes in taxes to fund public services—and a completely different matrix of individuals used those services. Given this dichotomy, establishing a definition of what constitutes the most fair way to levy taxes that is acceptable to everyone would be quite the difficult task.

Fortunately, there is a well settled definition of what constitutes fair taxation, at least in a capitalist society. According to none other than Adam Smith, the father of modern capitalism, a fair tax system is a progressive system, i.e., one that imposes a greater tax burden on affluent, than middle or low income taxpayers, when tax burden is measured as a percentage of income. In his seminal work, the Wealth of Nations, Smith explained the rationale for reaching this conclusion. He contended that under capitalism, affluent income classes will always benefit disproportionately from economic expansion. Since the greatest benefits would inure to upper income classes, fairness dictates they ought to have the greatest tax burdens, to support the government that delivers such economic benefits to them. According to Smith:

"The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state ….As Henry Home (Lorde Kames) has written, a goal of taxation should be to 'remedy inequality of riches as much as possible, by relieving the poor and burdening the rich.'"[1]

Figure 1



Center for Tax and Budget Accountability analysis of Economic Policy Institute and US Census data. Inflation based on Bureau of Labor Statistics CPI - U.

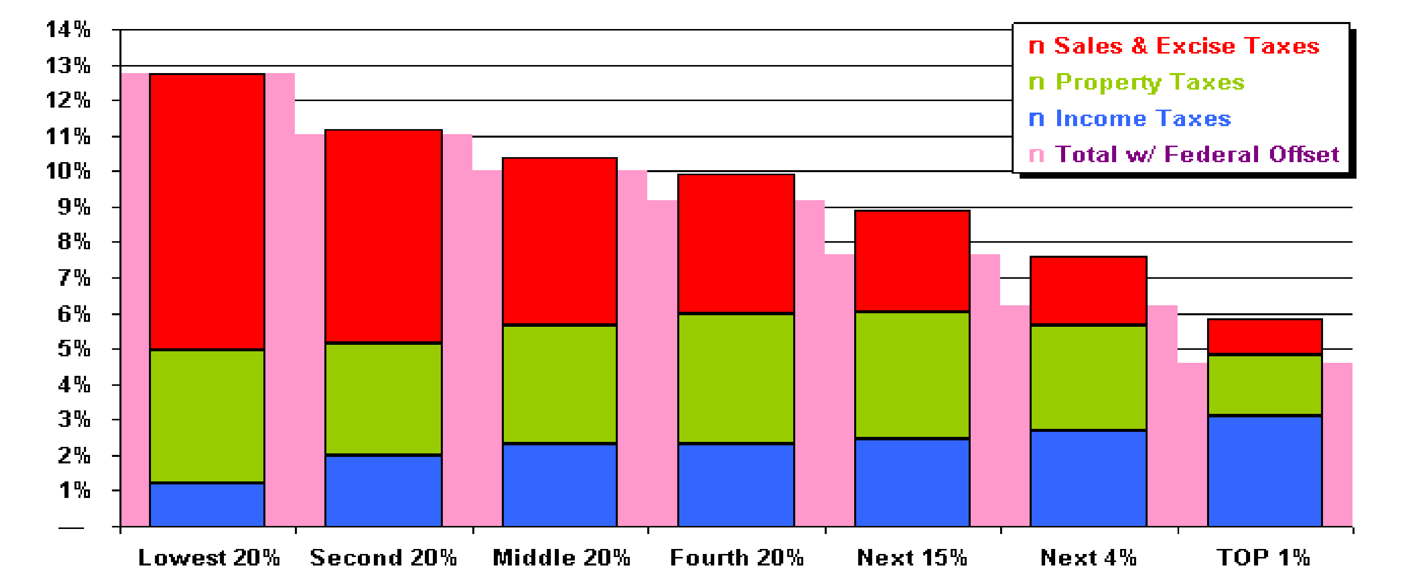
Was Adam Smith right? A review of Illinois' economic performance over the last three decades demonstrates that his reasoning was on target. As the following table illustrates, the vast majority of growth in the Illinois economy since 1979 went to the wealthiest 10% of taxpayers. In fact, the bottom 40% of income earners in Illinois actually took home less money on an inflation-adjusted basis in 2005 than they did in 1979.[2]

In light of what has really transpired in our economy, it is easy to understand why a progressive tax system is fair, and a regressive tax system would be considered unfair by most economists. In simple terms, low- and middle-income families are realizing either declining or stagnant annual incomes over time, while affluent families are realizing significant income growth. So, to impose tax burden in a manner which is fair to taxpayers of different income classes—and that responds to how the economy actually grows over time—Illinois should assess tax burden in a progressive manner, focusing the greatest tax burdens on the wealthiest 10 percent in income, who have realized by far and away the greatest income growth in the state.

Illinois Imposes Taxes in an Unfair, Regressive Manner.

As the following graph illustrates, tax burden distribution in Illinois is the opposite of fair.[3]

Figure 2
State and Local Tax Burden as a Percentage of Income
(Source: Institute on Taxation and Economic Policy)



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	$8,900	$22,600	$38,500	$61,100	$101,400	$203,600	$1,322,100
Tax Burden	**12.7%**	**11%**	**10%**	**9.2%**	**7.7%**	**6.2%**	**4.6%**

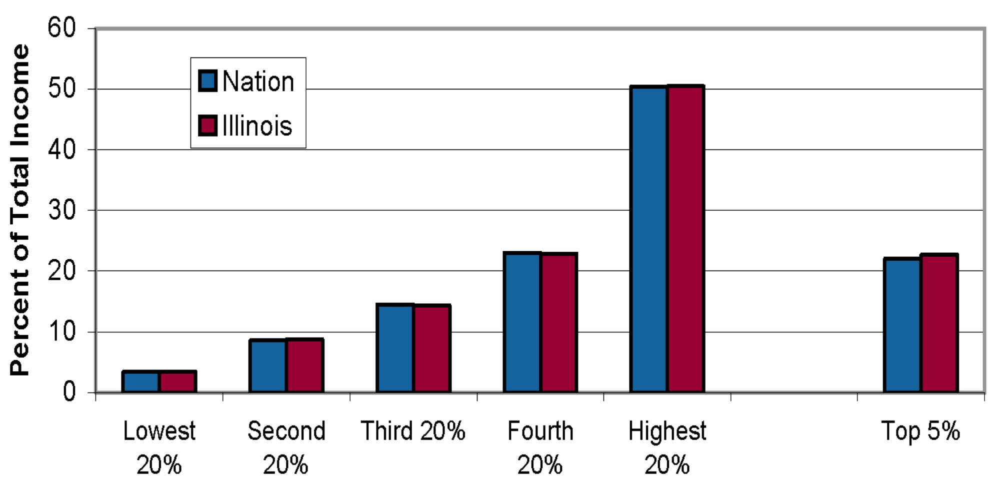
Effectively, the wealthiest Illinoisans, those with an average income of $1.3 million, pay 4.6 percent of their income in state and local taxes, while those with the lowest incomes, averaging less than $9,000 per year, have a tax burden that is almost three times greater than millionaires. Few people would consider a tax system to be fair if the poorer you are, the more of your income you pay in taxes. In fact, a central finding of the Institute on Taxation and Economic Policy's 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 state's income tax failed to offset the regressivity of the other taxes, like property, excise and sales.**

Illinois's Tax System Worsens Income Inequality.

One consequence of the state's unfair tax system is that it worsens growing income inequality between the wealthiest in the state and everyone else. The reason is easy to see. As incomes either decline or grow at much lower rates for middle and low income families over time, Illinois takes a much greater percentage of this diminishing or barely growing income in taxes to support state and local services, than it does from wealthy individuals. Figure 3 shows the extent of income inequality existing in the state and nation today.

Note that households comprising the wealthiest 20 percent of income earners, collectively own over half of all the income in both Illinois and the nation.

Figure 3
Shares of Household Income by Quintiles - 2006



Source: Analysis of CPS March 2007

As Figure 4 demonstrates, Illinois' regressive tax burden serves to worsen the income inequality naturally occurring as a result of the private economy.

Figure 4

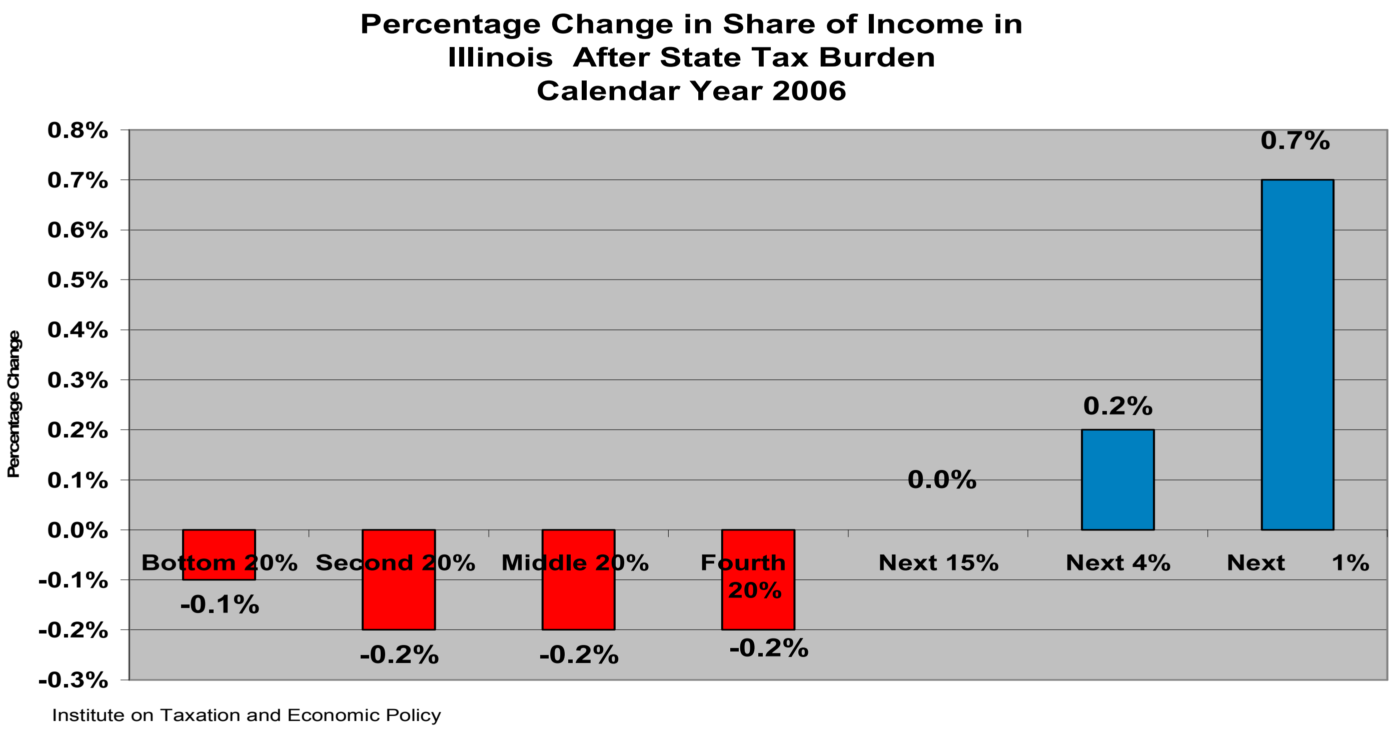
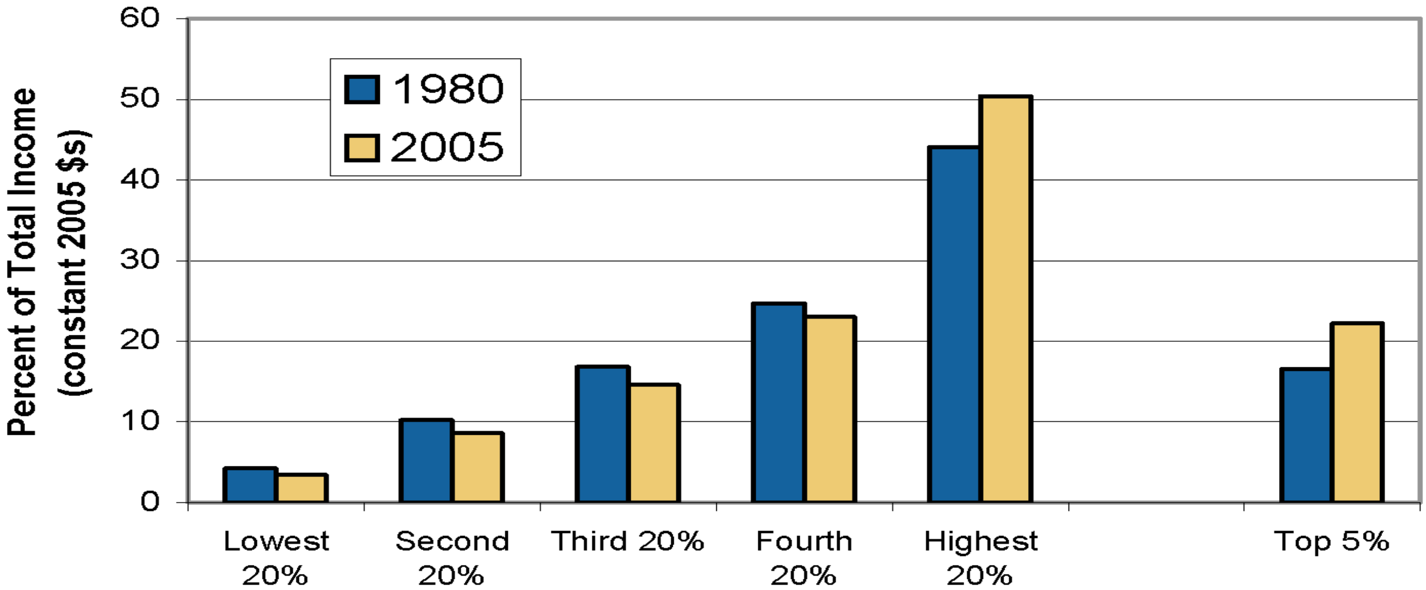


Figure 5 illustrates the growth in overall income inequality nationally, from 1980-2005 (Illinois specific data is not available for this full period).

Figure 5
Shares of US Household Income by Quintiles
1980 & 2005



Source: U.S. Census Bureau, Historical Income Tables

Illinois not only lacks progressivity in its overall tax structure, but also commences taxation at an income level lower than most other states.[5] While the income threshold for taxation increased slightly in FY2003 as a result of the state's Earned Income Tax Credit (**"EITC"**) being made refundable, Illinois' threshold remains one of the lowest among the 50 states.

Unfair Taxation Hurts the Illinois Economy.

Regressivity not only makes the Illinois tax system unfair, but also contributes to other problems for the state's fiscal system, economy and working families. Consider the fiscal system first. If the concept is to design a system that collects adequate revenue to sustain funding of essential services, then focusing on low- and middle-income families makes no sense. From a fiscal standpoint, low- and middle-income families not only make less money than their affluent counterparts, historically they also do not share in the nation's economic growth. In bottom line economic terms, low and middle income taxpayers are a poor revenue source, getting poorer over time. Focusing tax burden on a demographic that loses income over time necessarily means revenue collection will not keep pace with the economy. If the goal is to raise adequate, sustainable revenue for funding public services while maintaining low overall tax rates, then tax burden should be assessed primarily where income levels are high and expanding most generously over time.

In addition to being unfair and impeding revenue collection, a regressive tax system also hinders economic growth. The reasons for this are simple. First, since Illinois' regressive tax system fails to respond to growth in the modern economy, it contributes significantly to the state's ongoing, structural deficit problems. This in turn prevents the state from making the investments in infrastructure, transit, education and other priorities that are essential for Illinois to remain competitive in a global economy.

Second, roughly two-thirds of the national economy is consumer spending.[6] Low and middle income families are great consumers. As they obtain more income, they tend to spend it, and in the local economy to boot.[7] The reason for this tendency to consume rather than save is obvious, low and middle income families have less income over time to cover the cost of their basic needs than do affluent taxpayers. Hence, the wealthy have the luxury of saving, while poor and middle income families spend their full pay-checks. Since this is the case, designing tax relief that would actually stimulate the economy, that is, increase consumer spending, requires reducing tax burden for low and moderate income families, who will take their additional income and spend it. Instead, the state imposes a significant tax burden on low and middle income families, thereby hurting the economy by reducing the amount of money these families, our best consumers, actually have to spend.

How to Make the Tax System Fair for All

The only real sustainable solution is modernizing the state's tax system so it grows with the economy and is not overly reliant on the poor and middle class. This would require, among other things, income tax reform.

The Income Tax

The income tax is inherently fair because it is the only tax that actually increases or decreases its burden on a taxpayer in accordance with that taxpayer's ability to pay. If a taxpayer receives a raise, her income tax liability will increase. If on the other hand she loses her job, her income tax liability will decrease. No other tax adjusts its burden in accordance with a taxpayer's ability to pay.

Moreover, since an income tax can have a progressive rate structure—that it, impose slightly higher tax rates on individuals with higher incomes—a well designed, progressive income tax can actually help make a state's overall tax burden fair—or at least fairer than it would be without a progressive rate structure. The Illinois Constitution, however, prohibits lawmakers from setting marginal rates at different levels for different income classes, because it mandates a flat tax rate across all income brackets.[6]

This constitutional flaw can be addressed in a number of ways. The first and most direct would be an amendment to the Illinois Constitution that permits utilization of a progressive rate structure in the state's income tax. But the constitutional amendment process is time consuming—and the Illinois tax system is unfairly regressive right now.

A second approach, which should be pursued contemporaneously with a constitutional amendment, is using existing tax structures, like refundable credits and the dependent exemption, to create a more fair tax system today. For instance, the dollar value of the personal and dependent exemptions could be increased for low and middle income taxpayers, and reduced for higher income brackets. While this "reverse graduation" of these exemptions would create some progressivity—it would not get to the heart of tax burden for low and middle income families—who are hit hardest by payroll, excise, property and sales taxes. To address the main tax burden at the bottom and middle, refundable tax credits would be most effective.

A "refundable" tax credit is one that allows a taxpayer to receive the full dollar value of the credit, even if the credit is greater than the taxpayer's total income tax liability. This is effective because it offsets those taxes other than the income tax (like sales and payroll) that create the greatest burden for low and middle income families. Examples of refundable credits include the state and federal Earned Income Tax Credit and the Family Tax Credit included in House Bill/Senate Bill 750.

In the final analysis, the regressive nature of the Illinois fiscal system creates numerous impediments to building a bright future in this state. It also focuses the burden for supporting public services on those who are paying taxes from their growing poverty, rather than those who would be paying from their growing wealth. In either case, it is poor public policy.

References

1. Smith, Adam. The Wealth of Nations. Bantam Dell, New York, 2003, pg. 1043.
2. Center for Tax and Budget Accountability analysis of U.S. Census Bureau and Economic Policy Institute data. Inflation based on Bureau of Labor Statistics, CPI-U.
3. Institute on Taxation and Economic Policy. Prepared for the Center for Tax and Budget Accountability. Note: Table shows 2003 tax law at 2000 income levels.
4. United States Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation, "The 2002 HHS Poverty Guidelines."
5. Center on Budget and Policy Priorities. "Poor Families in Illinois Remain Subject to the Income Tax." Ranking among the 42 states with a personal income tax.
6. Illinois Constitution Article IX, Section 3.

About CTBA

Founded in 2000, the Center for Tax and Budget Accountability is a non-profit, bi-partisan research and advocacy think tank committed to ensuring that tax, spending and economic policies are fair and just, and promote opportunities for everyone, regardless of economic or social status.

CTBA uses a data-focused, bipartisan approach to work in partnership with legislators, community groups and other organizations to help change both public policy and perceptions.

Center for Tax and Budget Accountability
70 E. Lake St, Suite 1700
Chicago, IL 60601
Phone: (312) 322-1041
Fax: (312) 578-9258
Www.ctbaonline.org