Illinois Fiscal System

Frequently Asked Questions

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How do Federal and State Tax Systems Differ?

The federal government has primary responsibility for funding items of national interest, such as the post office, defense and social security. States are primarily responsible for funding education, police and fire service and similar matters of concern. While the federal fiscal system can deficit spend, states cannot. During times of economic downturn, states must either raise taxes or cut spending on programs to balance the budget.

There are three primary ways federal fiscal policy impacts state fiscal policy.

1. Direct Impacts—Some state-administered programs are based on federal law—such as the EITC— therefore, as federal law regarding the program changes, so does state law.

2. Indirect Impacts—Responsibility for many federal programs has transferred to states. The result? States find trouble funding programs because the federal government shifts operating responsibility without providing enough money to cover operating costs.

3. Impacts on Overall Burden of Taxpayers—As certain state taxes are deductible from federal taxes, those who can itemize deductions— more often the wealthiest taxpayers—are able to reduce their tax payments from 3% to 1.5%.

How does the Economy Impact State Systems and Individuals?

According to the Economic Policy Institute, between 1979 and 1999, the bottom 1/5 of income earners saw their annual income after taxes *decrease by* 8.9%. During the same period, the highest 1/5 saw their annual income *increase by* 33.2%, and the wealthiest 1% saw their annual income *increase by* 93.4%.

The state's fiscal system must be both prepared for changes in the economy and able to cover foreseeable needs. Otherwise, a "structural deficit" arises.

DEFINITION: Structural Deficit—When a state's tax revenue scheme, including types of tax, rates and base (items subject to a particular tax) will not bring in enough money to continue funding current service levels, with changing economic and demographic conditions taken into consideration.

Basics of a Sound Tax System

- It should be **fair**. Fairness can be measured either horizontally or vertically. Distributive impact of a tax system is key.
- It should be **responsive** to the economy. That means able to capture increased revenues in times of economic growth.
- It should be **stable** and able to maintain revenue collections during poor economic cycles.
- It should be **simple and transparent**. An easy to understand system reduces costs of taxpayer compliance and chance of taxpayer error. A transparent tax system increased confidence of taxpayers in their government and allows voters to make intelligent choices.
- It should be **efficient**. Taxes imposed should have minimal impact on the economic decisions taxpayers make.

Questions and Topics

Illinois Tax System — What Not to Do

Local and state governments raise revenue through taxes. These consist primarily of:

- Income tax - Property tax - Sales tax
- Excise tax - User fees

A proper mix of these taxes is essential to a sound tax system.

Illinois is a **very low tax state**. According to the Institute on Taxation and Economic Policy, if you include charges and user fees, the total tax burden in Illinois is among the lowest in the nation, ranking 47th out of 50.

Illinois has **one of the most regressive tax systems in the country**. According to the Institute on Taxation and Economic Policy, after federal offsets, the bottom 20% of income earners must pay 13.1% of their total income to the state in taxes, while the wealthiest 1% pay only 4.6% of their income.

"Illinois is bucking national trends. During the last decade, every other state in the country became less reliant on property taxes, but Illinois did just the opposite."

The unfair nature of the state's tax system is due to flaws in its basic structure. As illustrated below, **while Illinois income and sales tax burdens are less than national averages, its property tax burden is significantly higher.**

What Goes into Illinois Budget?

Out of the total state budget, a significant portion— around half of the budget— is funded through bond proceeds, federal transfers and other special sources.

The state's General Revenue Fund (GRF), which is used to fund the programs and services most commonly used by the general public, such as education and child care, is supplied by other sources. These revenue streams include particular federal transfers, which make up around 1/7 of the GRF, but are mainly comprised of personal income tax, corporate income tax and sales tax dollars.

Where is the Budget Deficit?

A budget deficit appears when the state's General Revenue Fund fails to have enough dollars to cover funding for commonly used public services. If tax revenue streams fail, then the state faces a fiscal **structural deficit**.

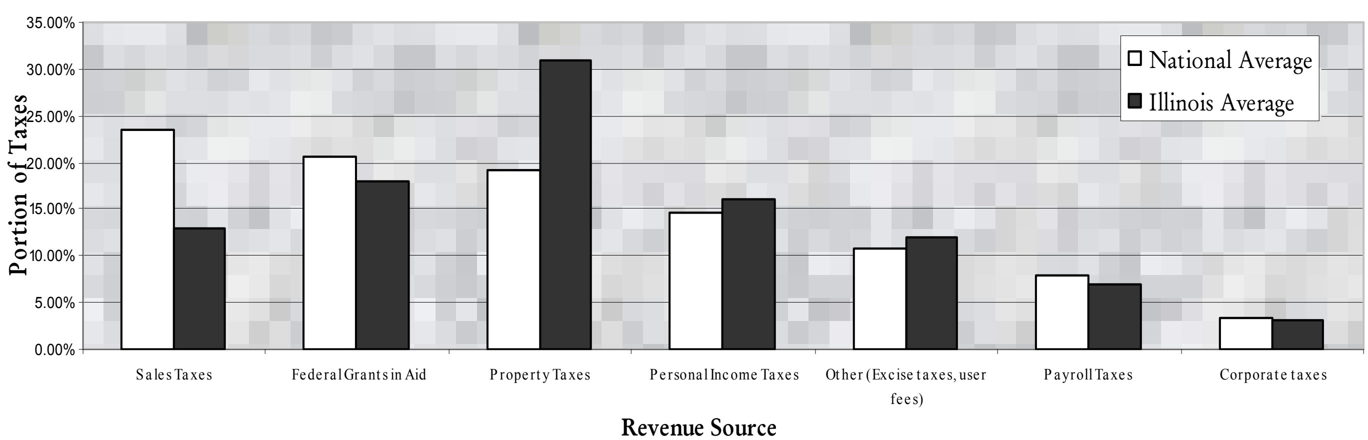
Deficits typically result in spending cuts to essential human services. If a state does not maintain a contemporary tax system, one that is both sound and responsive to the needs of state, basic and necessary programs face the chopping block.

The state's over-reliance on property taxes is due in large part to **constitutional constraints** imposed on the income tax system. As a result, Illinois generates more from property tax than personal income and sales taxes combined. This imbalance in revenue sources has a number of negative consequences for Illinois, most notably **inequitable education funding**.

According to the Illinois Survey, an opinion poll conducted by the Center for Governmental Studies at Northern Illinois University, *a vast majority of Illinoisans consider the property tax to be the least fair, most offensive state-imposed tax*. In the 1995 Illinois Survey, 57% endorsed increasing the income tax and reducing property taxes to fund public education.

Property tax reform is both **necessary** and **popular**.

Revenue Generation from Taxes and User Fees



Illinois Income Taxes

Although policymakers generally consider income taxes to be an essential component of making a tax system fair, the Illinois income tax fails to achieve this result. This failure is due to both constitutional restrictions and base level assessments.

Under the Illinois Constitution, the state's income tax must use a flat tax rate across all income brackets, and is prohibited from utilizing progressive tax rates which differentiate among income classes. This prohibits imposing slightly higher marginal tax burdens on the wealthy than on the poor.

Illinois' income tax rate or 3% is one of the lowest in the country, and is 21% below the national average.

Illinois' tax system is a serious roadblock to families trying to move away from welfare. Illinois not only lacks a progressive marginal rate structure, but also commences taxations at in income level significantly lower than in most states. Working poor families in Illinois who earn less than half of the federal poverty rate (around $18,104 for a two-parent family of four) have to pay state income taxes. By ignoring national standards, this system remains more than just unfair, it is also inflexible.

The State Tax system is not fully responsive to economic growth. Because Illinois is constitutionally prohibited from sing progressive taxation, the state income tax system does not capture appropriate additional revenue dollars in times of growth. State and local governments are forced to rely on regressive taxes— like property and sales— to make up for lost revenue. All but 6 of the 41 states with income tax have at least some progressive dimensions to their system.

Millions of dollars are lost annually from Illinois' tax exclusions. Illinois maintains significant exclusions from "taxable income" that are neither fair nor rational. For example, unlike the federal government, Illinois is one of the only three states that excludes all pension income from taxation, regardless of the wealth or income level of the pensioner. Hence, individuals of significant wealth who have large pensions are greatly favored under Illinois law. This would include former Governor Thompson, a millionaire, who will receive over $80,000 a year in pension income from the state of Illinois, tax free. Unfortunately, low income senior citizens who have little or no pension income and therefore must work to make ends meet, must pay the state income taxes on their wages.

The state collects significantly more revenues from personal income taxes than it does from corporate income taxes. There are three main causes:

1. Constitutional prohibition—The state can impose an income tax on corporations which is no more than 8/5 times greater than the rate it assesses against individuals. Currently, corporate rates are at 4.8%, the maximum allowed under this schema.

2. Flawed methods of assessment—The state recently changed its method of determining corporate taxable income, from a three part test to a "single sales" factor. The Illinois Department of Revenue estimates that this will result in a net revenue loss of approximately $98 million per year.

3. Irresponsible subsidies— The state loses significant revenue annually due to the numerous and generous tax expenditures it grants, many of which go to corporations. In Fiscal Year 2001, the state lost $5.5 billion in tax expenditures—$1 billion of which went to subsidize private enterprise—an amount which is 19% of the total general revenue, $29.4 billion, the state collected that year. **This is $1 billion more than the state transferred to all local governments ($4.47 billion) in FY2001.** The state has not implemented an accountablity methodology to ensure that these significant tax expenditures are wise invest-

Illinois' Tax Revenues
Individual Income Taxes:
$8.13 billion
Corporate Income Taxes:
$1.5 billion

The 25% **tuition tax credit** for education expenses in excess of $250 is a recent example of an expensive tax expenditure that fails to serve a legitimate policy purpose. While the idea is right— lower education costs— this tax credit primarily benefits wealthy taxpayers. And cost $70 million in lost revenue last year.

The state's **definition of income subject to taxation**, for both individuals and corporations, is closely tied to the federal definition. This has a direct and negative impact on the state's ability to collect revenues when the federal government gives tax breaks. This issue has proven to be particularly important under the current Bush Administration.

The state legislature recently increased **personal exemption** from $1,000 level established in 1969, to $2,000 (1997). When adjusted for inflation, to deliver the same relief as the 1969 exemption, the adjustment would have had to been at least $4,600 (1999).

Illinois Sales Taxes

Forty-five of 50 states impose a general sales tax. Illinois' state rate of 5% is in the middle of the national range and consistent with our border states. Illinois sales taxes are assessed under the rubric of the "*retailers occupation and use tax*" and the "*service occupation and service use tax*". The retailers occupation tax is assessed on the gross receipts retailers collect from selling tangible property in Illinois. The retailer's use tax is assessed on individuals who purchase property outside of Illinois but use it in-state.

The "service and occupation use taxes" are *not* imposed on services. Instead, these taxes are assessed on the tangible property acquired incident to purchasing a services. For example, auto repairs are taxed by the parts, not the cost of labor.

Presently, combined basic state and local rates for the sales tax come to 6.25% in Illinois, of which 5% is allocated to the state, an 1.25% to local governments. *There are at least 78 exemptions from the four types of sales tax in Illinois*, which cover a variety of items and taxpayers, certain types of machinery and equipment, medical appliances, medicines, food, certain farm machinery and chemicals, charitable and education organizations, non-profit exemptions and railroad equipment.

Taxing the Service Sector

What is the problem with Illinois' sale tax system?

The striking shortcoming of this system is that **Illinois state *sales tax does not apply to most services.*** As services increasingly become a significant part of our economy, they need to be included in the sales tax base in order to ensure a "stable" source of state revenue.

Determining which services should be taxed is a difficult task. Since sales taxes are regressive, care must be taken not to impose additional sales taxes that negatively impact the working poor. However, crafting sales taxes that apply to services primarily purchased by the wealthy, and adding or increasing existing refundable tax credits available to low-income families on their income taxes, would resolve these concerns.

Since the *service sector is the largest and fastest growing segment of the Illinois economy*, imposing a sales tax on services would create a system more responsive to real-world economic trends. **Services now account for more than 30% of gross domestic product in Illinois**. The next highest sector is *less than half* that amount.

As more and more businesses make use of services, the service-exemption becomes paramount to a business subsidy—businesses that are not otherwise given preferential tax treatment are compounding the revenue loss faced by the state.

Utilizing the state sales tax rate of 6.25%, the Illinois Economic and Fiscal Commission estimated that, in 1994, the sales tax on services would have generated $781 million in additional revenue for state and local governments in Illinois, which more than the $720 million in revenue that school funding lost due to tax expenditures in FY1998. Assuming the service economy was larger in 1998 than in 1994, assessing a sales tax on selected services could go a long way to covering the cost of property tax relief.

DEFINITION: Regressive taxes—While any change in tax code that is *not progressive* might be called "regressive", this short definition is highly political. A more salient definition of "regressive taxes" are those that place a heavier burden on low-income earners, by taking a higher portion of their income than they take from wealth, high-income earners. "Regressive taxes" of the second definition are characteristic of structural inequality.

Facts At-a-Glance

- The national average sales tax is 6.5%.
- Illinois average and weighted sales tax is 6.25%.
- Illinois exempts over 78 items from its four sales tax categories.
- Taxing services— strategically—would generate enough revenue to stabilize the General Revenue Fund and prevent structural deficits that lead to cuts in basic needs and social service programming.

Illinois Property Taxes

Illinois is reliant on local property tax revenues, particularly in generating funding for education. Since property taxes are local rather than state-based revenue, the quality of public school education is tied directly to the wealth of the local community.

Note the effect. Significant variations in property wealth around the state have created a *range in per-student funding, from $8000 to more than $1,300,000*. High property-wealth districts raise more money than their less affluent counterparts, which has a subsequent effect on quality of education offered to young learners. Less affluent districts, even when imposing property taxes to the limit of their capacity, frequently fail to generate enough revenue to fund even basic, quality education.

Disparities in school funding, and therefore, quality of education, would be significantly reduced if the primary basis for school funding was on state revenues.

Illinois property tax system is inherently complex. Few understand the algebra involved in the assessment and equalization process. In Cook County, these processes are even more arcane because of the 10 different classifications of property, each with their own rate and excep-

Effects of Property Taxation Inefficiency

Economists tend to agree that a well-designed property tax system is relatively efficient, meaning it does not distort economic decisions made by taxpayers. Unfortunately, *the Illinois property tax system is so burdensome and complex that it has a strong influence on home purchases and business development*. The level of systemic inefficiency faced by taxpayers, families and businesses alike, proves to be disastrous for communities.

When businesses or families of moderate to above-average income levels move out of an area, it forces the affected community to increase property tax rates even higher.

When faced with a declining tax base, ability to fund and provide services erodes. This higher tax rate is then assessed against the remaining, lower income residents.

Facts on Property Taxes

- In Fiscal Year 2000, Illinois collected $15.3 billion in property taxes. That is more than Illinois collected in personal income taxes– $8.3 billion– and sales taxes– $6.6 billion– combined.
- The national average for a state's share of education funding is just over 50%. In 1976, the Illinois state share of public education funding was 48.4%, barely below the national average. Twenty years later, the state's share of education in Illinois *declined to just 32.1%*.
- A combination of property tax caps enacted under the Property Tax Extension Limitation Act (1991), along with the establishment of foundation levels for public school funding in 1997 and Governor Ryan's commitment to utilize 51% of all "new revenue" for school funding, resulted in Illinois increasing its share of school funding to 37.6% in FY2000. According to Heartland Alliance, this places Illinois at 49th place, or **next to last in a ranking of states based on funds spent on education.**

Cook County's Property Tax Fiasco

Property tax assessments in Cook County are a prime example of the economic distortion caused by over-burdensome property taxes. For example, multi-unit housing is assessed at greater levels, resulting in greater property tax liabilities than a single-family residential unit. Because single-family residences are given a tax preference over multi-unit apartment dwellings, many apartments have been incentivised to convert to condominiums. Condos, which qualify for lower, single-family rates, are also favored by developers. Alongside the construction of condos or townhouses comes a decline in the number of apartments being built. A shortage of rental units— particularly those available and affordable to low-income families— has been just one of the negative, unintended consequences of the burdensome property tax system.

Reforming the Illinois Tax System

Because of the inefficiencies and inequities built into the Illinois tax system, most voters and bipartisan policy leaders, agree that the system must be reformed. A state with the financial capacity and diversity of Illinois should avail itself of the most efficient, reliable and equitable sources of revenue. This would ensure that Illinois can adequately fund a quality education for all of its children and provide essential services for our poor, disabled, elderly, infirm and homeless, while at the same time creating a fair distribution of the tax burden amongst residents.

Two primary goals of tax reform in Illinois

1. Eliminate the structural deficit to ensure the state can continue to provide essential services into the foreseeable future; and

2. Reform the way the state funds education, to break the tie between affluence of a community and the quality of public education it delivers.

Basic Elements of Systemic Tax Reform

A. Require accountability from all government spending, not just programs which help low-income families, the disabled, elderly, infirm or incapacitated, or which educate ur children.

B. Enhance income tax revenue by both increasing the rate and ensuring all meaningful types of income are subject to taxation. Increasing the rate to 5% from 3% will generate an additional $5 billion annually.

C. Increase the corporate income tax rate of 4.8%, depending on the increase in the personal income tax rate, to somewhere in the range of 6.4% - 8%. This will generate an additional $322 to $563 million annually.

D. Expand the sales tax base to include, at least, personal services and entertainment. This will generate $580 million per year in new revenue.

E. Require the state to fund a minimum of 50% of the cost of providing "quality education" to all public schools located in state, and provide about $2 billion in property tax relief in the new funding formula.

F. Eliminate or delay the state's requirement to repay the Rainy Day Fund the same year it is drawn, saving the state $226 million.

G. Create a means-test for the Illinois Tuition Tax Credit, saving the state $52 million while preserving this valuable credit for low– and middle-income families.

H. Allow taxation of pension income over $50,000, generating $340 million annually.

I. Develop means-testing for or eliminate the property tax credit, saving $100 to $300 million annually.

J. Improve collections from tax delinquents and other debtors, saving millions.

K. Eliminate tax breaks and subsidies given to horse tracks.

L. Review the federal definitions of Adjusted Gross Income for individuals and Taxable Income for corporations to determine if allowed deductions from those amounts make sense for Illinois.

M. Take advantage of federal deductibility when increasing specific taxes.

N. Design all tax revenue increases in a manner that does not have a negative impact on low– and moderate-income families, and/or use refundable tax credits to eliminate all such negative impacts.

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