CENTER FOR TAX AND BUDGET ACCOUNTABILITY

70 E. Lake Street • Suite 1700 • Chicago, Illinois 60601

FISCAL SYSTEM BASICS

1. What do Federal and State Tax Systems Fund, and How are they Different?

- Federal government has primary responsibility for funding items of national interest such as the post office, defense and social security. States have primary responsibility for funding education, police and fire service and similar matters of local concern.

- A primary difference between the federal and state fiscal systems is the federal government can deficit spend, but states cannot. Therefore, during a time of economic downturn, the federal government can maintain budgeted expenditures, but states must either raise taxes or cut spending on programs to balance the budget.

2. How does the Federal System Impact State Systems?

- There are three primary ways federal fiscal policy impacts state fiscal policy:

  (i) 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.

  (ii) Indirect impacts: In the past, states merely administered federal programs that were fully funded by the federal government. Now, however, responsibility for many federal programs has transferred to the states. This has resulted in funding problems, because the federal government establishes requirements, but in some cases does not give the state enough money to cover costs associated with operating the program.

  (iii) Impacts on overall tax burden of taxpayers: Certain state taxes are deductible from federal taxes. This tends to benefit affluent taxpayers, who can itemize deductions. In Illinois, for instance, the option to itemize deductions reduces the effective state income tax rate for the wealthiest from 3% to 1.5%.

3. What are the Basics of a Sound Tax System?

- An effective state tax system is predicated on the following 5 cornerstones:

  (i) It should be **fair**. Fairness of a tax system is measured in two ways, horizontally and vertically. Distributive impact of a tax system is key.

  (ii) It should be **responsive** to the economy - that is, able to capture increased revenues in times of economic growth.

  (iii) It should be **stable** and able to maintain revenue collections during poor economic cycles.

  (iv) 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 increases the confidence of taxpayers in their government and allows voters to make intelligent choices.

  (v) It should be **efficient** - that is, the taxes imposed should have minimal impact on economic decisions taxpayers make.

4. 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 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.
- A "structural deficit" simply means a state's tax revenue scheme, including types of tax, rates and base (that is, items subject to a particular tax) will not bring in enough money to continue funding current service levels, when changing economic and demographic conditions are considered.

5. What Goes Into the Illinois Budget, and Where is the Budget Deficit?

- You hear a lot about the state having a $53 billion budget. Is that the correct context for evaluating last year's record $2 billion deficit?
- The short answer is no. Out of the total state budget, a significant portion (about $28 billion) came from bond proceeds, federal transfers and other special sources that do not go into the state's general revenue fund (GRF is used to fund the programs and services most commonly used by the general public, such as education and child care).
- That leaves about $25 billion in GRF. However, of this amount, another $4 billion comes from other federal transfers. Only about $18 billion of the state's general revenue fund came from personal income taxes, corporate income taxes and sales taxes. Last year's $2 billion deficit was caused by failures in these revenue streams.
- Last year's deficit, and subsequent spending cuts to essential human services, illustrate why a sound tax system is essential. If tax revenues are not adequate, programs funded through GRF may face spending cuts.

6. The Illinois Tax System – An Example of What Not to Do.

- Local governments and state government raise revenue through taxes. These consist primarily of income taxes, property taxes, sales taxes, excise taxes and user fees. A proper mix of these taxes is essential to a sound tax system. Illinois' current tax "mix" is anything but "proper."
- 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 (unfair) tax systems in the country. According to the Institute on Taxation and Economic Policy, after federal offsets, the bottom 20% of income earners currently pay 13.1% of their total income to the state in taxes, while the wealthiest 1% pay only 4.6%.
- The unfair nature of the state's tax system is due to a number of flaws in its basic structure. As illustrated in Table A, while Illinois income and sales tax burdens are less than the national averages, its property tax burden is significantly greater.

TABLE "A" - Revenue Generation from Taxes and User Fees

Revenue Source	National Average	Illinois Average
Sales Taxes	23.6%	13%
Federal Grants in Aid	20.6%	18%
Property Taxes	19.1%	31%
Personal Income	14.7%	16%
Other (excise taxes, user fees)	10.7%	12%
Payroll Taxes	7.9%	7%
Corporate Taxes	3.4%	3%

- The state's over-reliance on property taxes is due in large part to constitutional constraints imposed on the income tax system. Due to these constraints, Illinois generates more from the property tax than it does from the personal income and sales taxes combined. The disproportionate amount of revenue raised from property taxes has resulted in a number of negative consequences for Illinois, most notably in education funding.

- Illinois also is bucking national trends. During the last decade, every other state in the country became less reliant on property taxes, while Illinois became more reliant on this revenue source.

- According to the Illinois Survey, a statewide 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 tax the state imposes. In the 1995 Illinois Survey, 57% of those queried endorsed an increase in the income tax and a reduction in property taxes to fund public education. Obviously, property tax reform is both necessary and popular.

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.

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

- Illinois not only lacks progressivity in its marginal rate structure, but also commences taxation at an income level significantly lower than most other 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. This is one of the lowest income levels to begin taxation in the nation. In addition to being unfair, this tax burden acts as an impediment for families trying to move off of welfare.

- Because Illinois is constitutionally prohibited from using progressive marginal tax rates, the state tax system is less responsive to economic growth than it should be. Since the state income tax system does not capture appropriate additional revenue in times of economic growth, state and local governments have had to rely on more regressive taxes, like property and sales, to make up for lost revenue. Notably, all but 6 of the 41 states with income taxes have at least some progressivity in their tax system.

- There also are significant exclusions from "taxable income" in Illinois which are neither fair nor rational. This results in millions of dollars of lost revenue. For example, unlike the federal government, Illinois is one of 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 tax on their wages.

- The state also collects significantly more revenues from individual income taxes ($8.13 billion in FY 00) than it does from corporate income taxes ($1.5 billion in FY 00). This is due primarily to three causes.

- First, constitutionally, 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, the corporate rate is 4.8%, the maximum allowed under constitutional constraints.

- Second, the state recently changed its method of determining the taxable income a corporation has in Illinois from a three part test to a "single sales" factor. The Illinois Department of Revenue estimates that this change in determining corporate taxable income will result in a net revenue loss to Illinois of approximately $98 million, per year.

- Third, 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. **It is also $1 billion more than the state transferred to all local governments ($4.47 billion) in FY 2001!!** Unfortunately, the state has not implemented any accountability methodology to ensure that these significant tax expenditures are wise investments of taxpayer money.

- 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. It cost $70 million in lost revenue last year, and benefits primarily wealthy taxpayers.

- The state's definition of "income" that is 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 feds give tax breaks, like under the current Bush Administration.

- Recent, limited efforts by the state legislature to address some of these structural problems have not gone far enough. For example, in 1997, Illinois increased the personal exemption from $1,000, the level it was established at in 1969, to $2,000. The increase was fully phased in by the year 2000. While a step in the right direction, it does not come close to providing low income families the same benefit as the $1,000 exemption did in 1969. When adjusted for inflation, to delver the same relief as the 1969 exemption of $1,000, the exemption would have to have been at least $4,600 in 1999.

Illinois Sales Taxes.

- Most states, 45 of 50, impose a general sales tax. The 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 retailers' use tax is assessed on individuals who purchase property outside of Illinois but use it in the state.

- Interestingly, the "service occupation and use taxes" are not imposed on services. Instead, these taxes are assessed on the tangible property acquired incident to purchasing a service. For example, when a car is repaired, this tax applies only to the parts included in the repair, not to the cost of labor.

- The present combined basic state and local rate for the sales tax in Illinois is 6.25%, which is allocated 5% to the state and 1.25% to local governments. There are at least 78 exemptions from the four types of sales taxes in Illinois. These exemptions cover a variety of items and taxpayers, and include 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.

- The main problem with the Illinois state sales tax is it does not apply to most services. As services increasingly become a significant part of our economy, they have to be included in the sales tax base for it to remain a "stable" source of state revenue. Determining which services should be taxed is tricky. 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, should address the regressivity concerns.

- Moreover, since the service sector is the largest and fastest growing segment of the Illinois economy, imposing a sales tax on services also will be 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. This could have a significant impact on generating revenues for the state.

- Services have not only become a greater part of consumer purchases, but also business purchases. Hence, even businesses that are not otherwise given preferential tax treatment are generating less revenue.

- 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 is more than the $720 million in revenue that school funding lost due to tax expenditures in fiscal year 1998. Assuming the service economy was larger in 1998 than 1994, assessing a sales tax on selected services could go a long way to covering the cost of property tax relief.

Illinois Property Taxes.

- Due in large part to the inadequacies of its income tax system, Illinois has become over reliant on local property tax revenues, particularly to fund education. As a result, Illinois property tax burdens are heavy and disproportionate compared to national averages.

- In FY 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. By 1996, the state's share of education funding in Illinois declined precipitously, to just 32.1%.

- The combination of the property tax caps enacted under the Property Tax Extension Limitation Act passed in 1991 ("PTELA"), 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 percentage share of school funding to 37.6% for fiscal year 2000. However, that is still well below the national average of 50%. According to the Heartland Alliance, Illinois ranks 49th in the country, next to last, in state funds spent on education.

- PTELA limited the increase in a local government's (other than Cook County's) total property tax bills to the lesser of 5% or the consumer price index increase. Unfortunately, all reforms implemented to date, including PTELA, have done little to alleviate the property tax burden, which remains substantial.

- Excessive reliance on property taxes has created disparities in school funding. Put another way, since property taxes are local rather than state-based revenue, the quality of the public education offered is tied directly to the wealth of the local community.

- This is because of the significant variations in property wealth around the state, which range from $8000 to more than $1,300,000 per student. The high property wealth school districts raise significantly more money than their less affluent counterparts, which translates to a higher quality of education offered to children in wealthy communities. Less affluent districts, even when imposing property taxes to the limit of their capacity, frequently fail to raise adequate revenue to fund even a basic, quality education. These disparities in school funding – and concomitantly – quality of education, would be significantly reduced if school funding was based primarily on state revenues (such as income and sales taxes) rather than local property tax revenues.

- Another significant problem with the property tax system is its inherent complexity. Few understand the algebra involved in the assessment and equalization processes. In Cook County, the assessment and equalization process is even more arcane because of the ten different classifications of property, each with their own rate and exceptions.

- The Cook County property tax system is so problematic that it has been challenged in the courts, and the state has established a special review agency, the Property Tax Appeals Board (**"PTAB"**), just to handle objections to individual assessments.

- PTAB has become a major problem, with primarily business using it to decrease, significantly, property tax assessments. This in turn reduces revenue local governments (primarily school districts) rely on.

- Economists tend to agree that a well designed property tax system is relatively efficient - that is, it does not distort economic decisions made by taxpayers. Unfortunately, the Illinois property tax system is so burdensome and complex that it does impact decisions about where to live or locate a business, making it highly inefficient. Many taxpayers, families and businesses alike, closely review local property tax rates, property values and available services when deciding where to locate or reside. The situation is exacerbated in Cook County, due to its classification system.

- 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 – as its tax base declines and its ability to fund and provide services erodes. Moreover, this higher tax rate is then assessed against the remaining, lower income individuals.

- Cook County provides a prime example of the economic distortions caused by over-burdensome property taxes. In Cook County, multi-unit housing is assessed at greater levels, resulting in greater property tax liabilities, than single-family residential units. Because single-family residences are given a tax preference over multi-unit apartment dwellings, many apartments have been incentivised to convert to condominiums, which qualify for the lower, single-family rates. Likewise, the incentive for developers is to create condominiums or townhomes, not apartments. Hence, a shortage of rental units – particularly those available for low-income families, has been one of the negative, unintended consequences of the burdensome property tax system.

7. Reforming the Illinois Tax System.

- Because of the inefficiencies and inequities built into the Illinois tax system, most voters, as well as Democratic and Republican 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 will 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 among its residents.

- Two primary goals of tax reform in Illinois should be:

  - Eliminating the structural deficit to ensure the state can continue to provide essential services into the foreseeable future; and
  - Reforming the way the state funds education, to break the tie between affluence of a community and the quality of public education it delivers.

- The basic elements of systemic tax reform should include consideration of the following:

  (a) Requiring accountability from all government spending, not just programs which help low-income families, disabled people, the elderly, the incapacitated and the infirm or which educate our children. This will require a thorough review of all tax expenditures, Member Initiative spending and the state's purchasing practices for big ticket items, like prescription drugs.

  (b) Enhancing income tax revenue by both increasing the rate and ensuring all meaningful types of income are subject to taxation. Increasing the rate from 3% to 4% will generate $2.5 billion, increasing to 4.5% will generate $3.7 billion and increasing to 5% will generate $5 billion per year in additional revenue.

  (c) Increasing the corporate income tax rate from its current level of 4.8% to 6.4%, 7.2% or 8%, depending on the increase in the personal income tax. This will generate $322 to $563 million annually.

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

  (e) Requiring the state to fund at least 50% of the cost of providing a "quality education" to all public school students located in the state and provide about $2 billion of property tax relief in the new funding formula.

  (f) Eliminating or delaying the state's requirement to repay the Rainy Day Fund the same year it is drawn, saving the state $226 million.

  (g) Creating 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) Illinois is one of only three states that exempts all pension income from taxation, costing the state over $530 million annually. Subjecting pension income over $50,000 to taxation would generate $340 million annually.

(i) Means-testing or eliminating the property tax credit, saving $100 to $300 million.

(j) Improving collections from tax delinquents and other debtors, saving millions.

(k) Eliminating tax breaks and subsidies given to horse tracks.

(l) Review of 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) Taking advantage of federal deductibility when increasing specific taxes.

(n) Designing 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.

For further information, please contact Ralph Martire, Executive Director, at 312/332.1049 or visit our website: www.ctbaonline.org