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Q & A on House Bill 174

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House Bill 174 would change the Illinois tax structure in a number of ways. It would raise between \$5.0 billion and \$5.2 billion in new, recurring tax revenue, provide tax relief to homeowners and low income families, and provide additional funding for public schools, and health and human services. The bill does this in the following ways:

- Increases the individual income tax rate from 3% to 5%.
- Increases the corporate income tax rate from 4.8% to 5%
- Increases the standard exemption for individual taxpayers from \$2,000 to \$3,000
- Provides property tax relief by doubling the personal income tax credit for homeowners from its current level of 5% of property taxes paid to 10%, and makes this refundable, up to \$1,500. (A taxpayer always receives the full value of a refundable income tax credit. So if the dollar amount of the refundable credit exceeds his or her income tax liability, that taxpayer would receive a check for the difference. This only applies to an Illinois homeowner's principal residence.)
- Triples the state's refundable Earned Income Tax Credit (EITC) from 5% to 15% of the federal EITC claimed by an Illinois taxpayer.
- Expands the sales tax base to include 39 different consumer services, similar to what neighboring states have done.
- Enhances education funding beginning in the second fiscal year after the bill passes by dedicating 33 1/3 of all new revenues generated by HB 174 to the Common School Fund. To ensure that this really enhances school funding rather than merely replacing existing school funding revenue streams, HB174 requires that the new revenue dedicated to schools under the bill be added to the appropriation amount from the previous year.
- Enhances Higher Education by dedicating 16 2/3 percent of all new revenues generated by the bill to universities and community colleges. The remainder of the new revenue goes into the State General Revenue Fund.



The Following questions have been asked regarding this legislation.

1. Won't the Governor's proposed 1% income tax surcharge for education fix the problem?

- No. Governor Quinn has asked for an increase from 3% to 4% in the state's individual income tax rate, and from 4.8% to 5.8% in the corporate tax rate, to help avert the \$1.25 billion cut in K-12 education funding currently called for in his FY2011 budget proposal. CTBA estimates that, at best, this increase would raise about \$3.6 B in General Fund revenue.
- Unfortunately, even though the Governor's proposed FY2011 General Fund budget is cut by almost \$2 billion from FY2010 levels, the state is still facing an FY2011 General Fund budget shortfall of over \$10 billion, as shown in Figure 1.

Figure 1
Analysis of FY2011 General Fund Budget Proposal

Starting Revenue Shortfall	\$ 13.259 B
FY2011 General Fund Total Appropriations	<u>\$ 24.508 B</u>
TOTAL FY2011 Revenue Needed	\$ 37.867 B
Estimated FY2011 General Fund Revenue	\$ 21.412 B
Estimated FY2011 Federal Transfers (including Stimulus)	\$ 6.032 B
"Strategic" Debt to Cover FY2011 Services	<u>\$ 4.7 B</u>
TOTAL ALL Revenue and Bank Debt to Cover FY2011 Revenue Needs	\$ 32.144 B
Revenue Shortfall that is Effective Borrowing from Providers, in the form of Deferring Payments owed for FY2011 Services into FY2012	\$ 5.723 B

Sources: OMB Illinois State Budget FY2011 and CTBA Jan. 2010 Fact Sheet: "Illinois State Deficit Problems"

As shown in Figure 1, the state needs to raise almost \$38 B (\$24.5 B proposed budget plus \$13.3 B starting revenue shortfall) to cover its General Fund budget in FY2011. FY2011 General Fund own source revenue is estimated to be \$21.4 B. FY2011 Federal Transfers including stimulus are estimated to be \$6.0 B. This leaves an FY2011 budget hole of over \$10 B.

- The \$3.6 B from the 1% for education is, thus, nowhere near enough to "fix the problem," even if the General Assembly goes along with the Governor's proposal to incur "strategic borrowing" of \$4.7 B from banks to cover basic expenditures on services in FY2011.
- In contrast, since HB174 would raise over \$5 B in new revenue, it would nearly eliminate the entire remaining FY2011 shortfall, while generating significantly more ongoing revenue to support seniors and reduce deficits moving forward. (See: "FY2011 Proposed Budget Analysis," CTBA, March 2011.)

2. Which households will be most impacted by the 1% surcharge versus HB174?

- Because the Governor's proposed 1% surcharge for education is strictly a tax increase which provides no associated tax relief that could benefit low and middle income families, it is regressive. In effect, every taxpayer would face a one percent income tax rate increase, even the lowest income households. So even if the Governor's proposal "fixed the problem"— which it doesn't—it would do so disproportionately on the backs of those least able to afford it. HB174, on the other hand, would actually cut taxes for an estimated 40% of low income households and retirees because of increased deductions and tax credits that are included in the bill. Putting similar increased deductions and credits in Governor's proposed 1% for education would reduce the already too little revenue it raises by about \$1.3 B.
- Ironically, the Governor's 1% for education proposal would make the Illinois tax system more unfair than it is today. This is hard to justify, given that Illinois is already the sixth most unfair taxing state in the nation. (See: "Who Pays?," Institute on Taxation and Economic Policy, October 2009).
- Illinois currently has the lowest state income tax rate on high income filers in the country (among all states with an income tax). In the future, taxes will have to be raised on high income households in Illinois as these households have captured the lion's share of income growth over the last few decades.

3. Wouldn't the surcharge become a permanent income tax increase?

- Yes. Given Illinois' current level of indebtedness and massive shortfalls in current operations funding, it is highly unlikely that the state would be able to repeal the "surcharge" without causing panic in bond markets and severe disruptions in state operations.
- Moreover, it is highly likely the surcharge will become permanent, or the only revenue enhancement that Illinois adopts for decades, because the General Assembly simply does not like to, and in fact has a history of not, passing significant revenue increases more than once every 20 years or so. Hence, passing the governors 1% proposal, which generates inadequate revenue in an unfair fashion, would in all likelihood preclude Illinois from enacting more comprehensive and sustainable fiscal reform, and consign the state to ongoing deficit problems for the foreseeable future.

4. Won't the pension reforms work and make things better?

- The recently passed pension bill is estimated to reduce state FY2011 pension payments by \$300 M to \$1 B (Chicago Tribune, 3/24/2010 "Illinois Lawmakers Rush Through Pension Reforms") from what they would otherwise be.
- However, the state's current "pension ramp" obligations have not yet been fully adjusted to account for recessionary investment losses that are estimated to have increased Illinois' largest in the nation pension debt from \$77 B to \$90 B (see 3/24/2010 Tribune article).
- Given this large increase in Illinois pension debt, it is unlikely that Illinois required pension payments will decline even after taking the pension bill into account.

5. Would managed health care help relieve the pressure on the budget deficit?

- No, Swings would be minimal.
- With the limited data available, it is unclear whether managed care will save the state money. If done right, managed care has the potential to stem emergency room visits and hospitalizations by improving access to primary care services, which could result in program savings. However, on the flip side, better coordinated care would likely result in an increase in specialty care, thereby increasing some program costs. Therefore without more data, it is not clear whether Medicaid managed care would result in overall reduced Medicaid costs.

- In addition, further study needs to be done to ensure that any managed care program does not have the effect of limiting the amount of federal funds Illinois hospitals receive through the upper payment limit rules.
- CTBA is in the process of doing a full analysis on the fiscal impact of the Governor's proposed Integrated Care Program pilot (Medicaid managed care).

6. Is a tax increase a good idea during a recession when people are struggling financially?

- Yes, although increasing taxes is a difficult option, if structured the right way a progressive tax increase can actually maintain or grow jobs. The one, clear, worst option for the state's economy, however, is significant state budget cuts.
- Applying multipliers developed by Moody's.com chief economist Mark Zandi (See: "Moving Forward," CTBA March, 2009) to the most recent Federal Bureau of Economic Analysis labor data, the roughly \$1.8 B in proposed FY2011 budget cuts will in all likelihood cause Illinois to lose about 36,000 private sector jobs, over and above the direct job loss for those workers who provide public services and are fired due to the cuts. Simply put, it is textbook economics that because the "balanced budget multiplier" is positive, taxing and spending during a recession expands economic activity and creates jobs. The alternative of cutting spending rather than increasing taxes reduces economic activity and destroys jobs.
- To the extent that tax increases are targeted toward higher-income households who can more easily afford them, rather than toward lower income households who are more likely to spend their income in the local economy, this "balanced budget multiplier" affect on stimulating the economy will be greater. Because HB174 in fact focuses its tax increase on higher income taxpayers who can more readily absorb it without diminishing their spending, it can be expected to have a much more positive impact on stimulating the state's economy than the Governor's 1% surcharge, which is regressive.

7. Is HB 174 a tax swap?

- No. There is no swap of increased income taxes to replace property taxes. HB174 does provide property tax relief, however, by doubling, and making refundable up to \$ 1,500, the current state income tax credit homeowners can claim for the property taxes they pay on their principal residence in Illinois as described above in the introduction to this Fact Sheet.

8. Shouldn't budget reform be done before a tax increase?

- If "budget reform" is taken to mean cuts in the over 90% of state spending that supports education, health care, human services, and public safety, the short answer is *no*. The data indicate Illinois is already spending *too little* to provide these four, core public services, and the Governor's proposed FY2011 budget cuts of \$1.8 B would devastate already poorly funded state services (See: "Analysis of Governor Quinn's General Fund Budget Proposal for FY2011," CTBA, March 2010).
- According to the most recent 2008 Census data, Illinois is 43rd in State General Fund spending relative to GDP, and based on the most recent 2007 data published by the Federation of Tax Administrators, Illinois is ranked 46th in total state and local tax burden (including all taxes and fees charged by any unit of state or local government in Illinois) relative to personal income. This means that *relative to its capacity* to support public services Illinois is doing very little compared to other states.
- Illinois' status as a low-spending state applies to key areas of funding such as education and human services. According to the latest (2006-2007 Gov Census data) Illinois is 46th in state per-capita education spending and in FY2002 (before \$4.4 B in cumulative cuts) 35th and 40th in per-income funding for mental health and developmental disabilities (See: "Illinois Funding for Human Services in Context", CTBA Feb. 2010).

- These low levels of funding support a very small state labor force. According to a 2008 census of state employment, Illinois ranks 49th in per-capita non-education full-time equivalent state employment.
- None of this means that public spending cannot, or should not be “reformed” to provide greater accountability and more efficiency in the provision of public services. What is clear is that any such reforms will not generate sufficient savings to make up for either the state's ongoing fiscal deficiencies or its failure to fund core services adequately.

9. Some say the education budget has increased much faster than the Consumer Price Index which should be more than enough to support good schools. Why didn't that help?

- The premise of this argument is false.
- As has been noted above, in 2006-2007 Illinois was 46th among states in per-capita education spending.
- Rather than trying to improve this lack of support for public education, over the long term, the data show Illinois has cut its funding for public education after adjusting for inflation using the Consumer Price Index (K-12 by over 3%, and Higher Ed by over 25% since FY2000). The picture gets worse when state spending is adjusted for both population and inflation, using the CPI, with K-12 funding cut by 4.1%, and Higher Ed cut by 32%. (See: Proposed FY2011 Budget Analysis, CTBA March 2010.)
- The Consumer Price Index, while a great metric for assessing inflationary changes in the economy as a whole, is not particularly useful for evaluating spending on services, because the CPI includes price changes in millions of items, e.g. pop tarts, refrigerators and neck ties that are simply not purchased by state government.
- Most public services are highly labor intensive. The inflation metric that best tracks increases in labor costs over time is the Employment Cost Index or ECI. Adjusting state spending for population growth and inflation using the more accurate ECI shows that from FY2000 through FY2010 Illinois cut spending on K-12 education by \$443 million, and cut spending on Higher Education by \$1.325 billion. Obviously, if the Governor's proposed FY2011 budget becomes law, those cuts would become significantly worse.

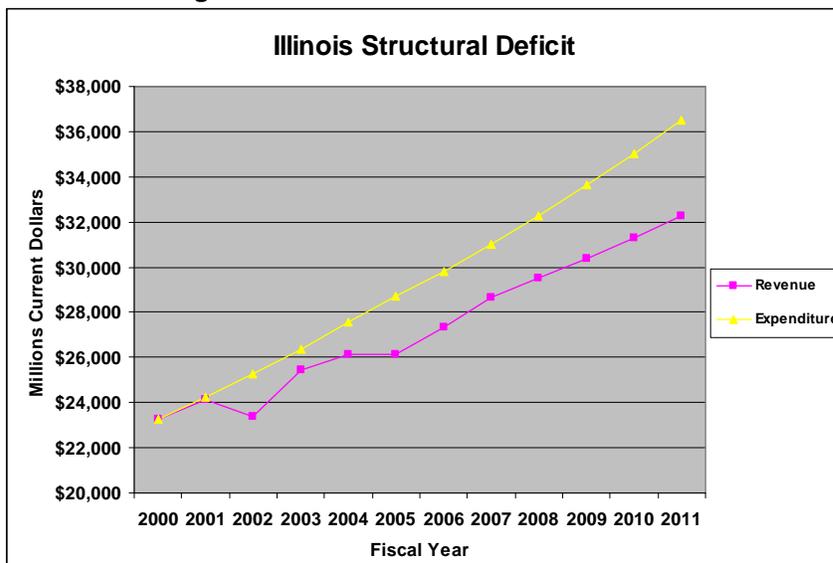
10. Senator Meeks is supporting choice and vouchers. Isn't that the best idea?

- No, general public education cannot be fixed by cream skimming the best and most motivated students and parents into charter or private schools. This is the considered opinion of highly respected education scholar Diane Ravitch, one of the early supporters of choice, vouchers, and charter schools, who after looking at the evidence changed her views. While some flexibility and choice between publicly funded schools with similar constraints may be helpful in some circumstances; the evidence shows that charters, choice, and vouchers do not improve public education outcomes for the vast majority of students, and are sometimes harmful to general public education.
- All public schools, and especially schools serving low-income students, need skilled and motivated teachers and solid curriculum. A necessary, though not sufficient, condition for this is greater and more equitable, funding for education.
- Illinois ranks as the 46th lowest per-capita spending state on K-12 education in the nation. Conversely, this means that most public funding for education (over 77% according to the most recent census data) comes from local sources. This causes increasing educational funding disparity among wealthier and poorer districts and limits the ability of poorer districts to raise funding that is commensurate with their needs. The only way to correct this problem statewide is to increase the state's investment in education funding to reduce the overreliance on property taxes.

11. What is the structural budget deficit? How will HB174 address that problem?

- The "structural deficit" is the amount by which revenue growth under normal economic conditions (not years of exceptional economic downturn or upturn) based on current state taxes and fees fail to keep pace with the increase in the cost of providing core public services that are caused by inflation and population growth alone. If a state—like Illinois—has a structural deficit, its revenue growth over time will not keep pace with service cost growth, even if no new public services are added, and no existing services are enhanced or expanded.
- The structural deficit is based on the difference between the normal growth rate of state revenue and necessary growth rate of state expenditures. It is, therefore, unrelated to the question (addressed in 8 above) of whether the levels of state funding of the four, core public services is adequate. As noted above, Illinois' funding levels (regardless of growth rates) for vital services like public education and human services is very low compared to other states.
- Figure 2 shows a graphic depiction of the Illinois General Fund structural deficit from FY 2000 through FY2011. It assumes a normal (FY2000 to FY2007) economy, and no new or expanded services (other than for population growth) from FY2000. From FY2000 to FY2007 it uses actual General Fund revenue data. These are projected to FY2011 using historic rates of change from FY2000 to FY2007. FY2000 expenditure is assumed to equal FY2000 General Fund revenue. Expenditures for FY2001 to FY 2007 are set equal to FY2000 expenditure adjusted for inflation using current ECI and population growth, only. Expenditures for FY2008 to FY2011 are set to FY2000 expenditure using average ECI and population growth rates for the FY2000 to FY2007 period.

**Figure 2
General Fund Structural Deficit Assuming FY2000
Balanced Budget and FY2000 to FY2007 Economic Conditions**



Sources: CTBA calculations from: COGFA FY2010 Budget Summary p. 62, BLS ECI Index, and IL DCEO population estimates.

- The data indicate that, under optimal conditions, Illinois would have a structural deficit of around \$4.2 billion in FY2011, which if left in place would generate even greater structural deficits in the future. This is undoubtedly an underestimate of the actual current structural deficit as economic conditions are likely to be significantly worse than those of FY 2000 to FY 2007 for many years to come. For starters (as of Nov 2010) non-farm employment in Illinois had dropped by over half a million (7% of its pre-recession Dec

2007 total), with over a quarter of job losses in key export sectors like manufacturing which, when this is due to plant closings may be nearly impossible to regain in the near future.

- The state's actual FY2011 starting deficit is over \$13 billion because of the ongoing structural deficit, past borrowing, recession induced revenue shortfalls, and increased pension ramp requirements. The Governor's FY2011 budget proposes to close this gap by massive cuts in state spending of \$1.8 billion, an estimated and hoped for \$6 billion in federal support, more "strategic borrowing" to fund current operations of \$4.7 billion, and roughly \$5.7 billion in continued "deferred" payments to non-profit service providers and other state contractors. Needless to say, if implemented this proposed budget will impose extreme, and in many cases irreparable, harm to current and future public services, especially K-12 education which would be hit by the largest \$1.2 billion cut in recent state history (See Figure 1 above and CTBA Analysis of FY2011 Proposed Budget and Human Service reports).
- Though the state can and should work to improve its economic prospects as much as possible (especially by providing education, infrastructure, and funding for well-paying public service and high value added manufacturing jobs that have the largest multiplier impacts on the state economy and are essential to a U.S. economic revival), states have limited ability to influence general national and international economic conditions. Realistically this implies that the only way that the state can overcome its structural deficit problem is to reform its tax structure. Moreover, this reform will need to raise significant revenue, well beyond the \$3.6 billion that can be anticipated from the Governor's proposed 1% surcharge, to offset the state's structural deficit that will be significantly larger than the \$4.2 billion estimated above under "optimal" conditions. Additional revenue is necessary to increase funding for Illinois' woefully and chronically under-funded education and human service sectors, to address Illinois' state pension funding crises and to pay back the massive debts and deferred payments to vendors that have been accumulating for years. A large, HB 174-level \$5.0 billion to \$5.2 billion revenue enhancement, and not a small 1% \$3.6 billion surcharge, is the minimum necessary.
- There are two fundamental problems with the current state tax structure. It is highly regressive, and it taxes goods but not services. The regressivity has been documented in answer 2 above. Given the state constitution requirement that there be only one flat income tax for all state income taxpayers regardless of ability to pay, establishing a progressive income tax rate structure would require a constitutional amendment.
- HB174 attempts to at least partially address regressivity within the current constitutional framework, by increasing the standard exemption, earned income tax, and property tax, credits and making the later refundable. As noted above, the Governor's 1% surcharge proposal does none of this and in fact would make the Illinois tax code even more regressive than it already is.
- The second major problem is that the state's sales tax currently applies primarily to the sale of goods and not services. This significantly reduces revenue growth from the state sales tax as the service share of the Illinois economy has continuously expanded, even as the goods share has declined. HB 174 takes a first step in addressing this by expanding the sales tax to include 39 hitherto untaxed Illinois services, almost all of which are taxed in one or more surrounding mid-west states.

12. Wouldn't this bill hurt small businesses?

- No. Under HB174, the Illinois corporate income tax would increase by just two-tenths of one percent (0.2%). This in and of itself would have an insignificant impact on businesses in Illinois. Moreover, most small businesses are organized as either limited liability companies or "S" corporations and thus are not required to pay corporate taxes.
- Small business owners who have not incorporated will face the same tax changes as other individual income tax payers. However, as most small businesses do not compete out of state, this will not disadvantage (or advantage if HB 174 results in a tax cut) these businesses relative to their competitors who will face similar tax changes.

13. I heard my school district is making drastic cuts. Would this bill help?

- Yes. It raises more than enough to prevent the \$1.2 billion in K-12 education funding cuts contained in the FY2011 budget proposal.
- Better still, in succeeding fiscal years, HB174 designates 33% of all new revenue **it raises to increase K-12 education funding from prior year levels**. This would be an almost 24% increase in state funding for K-12 education over FY2010.

14. I have to live within my means; shouldn't the state do the same?

- The answer is yes, but only if your means support life. In the case of Illinois, its structural deficit means the state cannot solve its fiscal problems long term without passing a significant revenue increase generated through comprehensive tax reform.
- This whole line of thinking reflects the “fallacy of composition”. What is good for one individual household is not necessarily good for the state or national governments. By trying to “balance the budget” during the Great Depression, President Hoover made the Depression worse. Individual states like Illinois are constitutionally bared from deficit spending, and Illinois has already borrowed about as much as it can and then some. Under these circumstances the best course of action for the state, as noted above, is to raise taxes in as progressive a manner as possible, and increase state spending, especially spending that increases productive employment in the state.
- If “living within its means,” means that the state should cut its budget to match its revenues, this would simply make the current severe recession, and ultimately the state’s budget picture, worse, exacerbating a downward cycle of economic contraction and falling revenues.

15. My legislator says that new taxes would be a blank check for the Governor to pay for new programs.

- Given the state’s massive deficits and under-funding problem it would be difficult to impossible for new funds to be used for “new programs.” The state’s bond ratings would collapse and the state would be unable to function. This seems like a very unlikely scenario even in a “politically compromised” state like Illinois.

16. Won't higher taxes discourage business from staying in or coming to Illinois?

- No. Despite ranking as one of the lowest taxing states in the nation and the Midwest, Illinois’ economic growth rate has lagged the higher tax Midwest and nation for over 20 years. Many factors other than tax burden, such as predictability of tax structure (Illinois' is not predictable due to its structural deficit), quality of education, infrastructure, and geographic links, are important determinants of business location decisions.

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