

Understanding Tax Fairness

Conference Call Summary

Voices for Illinois Children

April 8, 2009, 9:30 a.m.

Tax Fairness

Larry Joseph, director of Voices' Budget & Tax Policy Institute

Income Taxes in Illinois and Other States

The individual income tax is the state's single largest source of revenue, accounting for more than one-third of total General Funds revenue in FY 2008. The Illinois constitution requires that any state income tax be levied at a flat rate. The individual income tax has been set at 3 percent for individuals since July 1989. Among the 41 states that impose taxes on earned income, only six have flat rates—ranging from 3 percent in Illinois to 5.3 percent in Massachusetts.

In addition to its low rate, the Illinois income tax has a low threshold for taxable income; the state has a small standard exemption (\$2,000) and no standard deduction or itemized deductions. Ten states use the federal standard deduction; in tax year 2008, the standard deduction was \$10,900 for married couples filing jointly, \$8,000 for single heads-of-household, and \$5,450 for single individuals. Twenty states have personal exemptions that are higher than the \$2,000 level in Illinois. Eight of these states use the federal personal exemption, which was \$3,500 in tax year 2008.

Progressivity without Graduated Rates

The Illinois constitution prohibits graduated income tax rates, but it does not preclude a progressive tax structure. A graduated income tax applies higher *marginal* rates to higher levels of income. Progressivity refers to the *average effective* tax rate, i.e., taxes as a percentage of household income. A progressive tax system is one in which households with higher incomes have higher effective tax rates. A regressive tax takes a larger percentage of income from lower income households. A proportional tax has the same effective rate for all income levels.

A simple example illustrates how exemptions can enhance progressivity. Consider two single-person households with incomes of \$10,000 and \$100,000. With a 3 percent income tax and no personal exemption, both households would have the same effective rate (3 percent); the income tax would be proportional. A \$2,000 exemption would introduce a small amount of progressivity. The low-income household would pay \$240 (2.4 percent), while the high-income household would pay \$2,940 (2.94 percent). Raising the exemption to \$4,000 exemption would make the tax structure even more progressive—with effective tax rates of 1.8 percent and 2.88 percent.

A flat-rate income tax can be made more progressive by using standard deductions, personal exemptions, and targeted tax credits. The Governor's proposal would raise the individual income tax rate from 3 percent to 5 percent and increase the standard

exemption from \$2,000 to \$6,000 (while eliminating the additional exemptions for the elderly and blind).

Tax Reform Debate: The Governor's Proposal and Other Options

Sean Noble, director of Government Relations

- Voices for Illinois Children values both adequacy and fairness in revenue improvements.
 - Adequacy, to better support a wide range of programs—education, health and human services—that are important to families, but suffer from currently inadequate revenues
 - Fairness, to help protect struggling families who already spend an unfairly high share of their incomes in state and local taxes—and, hopefully, provide them with tax cuts
- Voices supports Governor Quinn's proposal for an income tax increase, as this tax hasn't been raised in 20 years and is the biggest and strongest revenue stream to which we can turn—and it represents the greatest possibilities for fairness, since it reflects families' ability to pay better than other taxes. The Governor would raise the personal income tax to 4.5 percent from its current level of 3 percent; Voices could even support a slightly higher increase
- Voices also supports the Governor's call for fairness via an increase in the tax's standard exemption, which shields a certain amount of household earnings from taxation. This helps families at all income levels, but would particularly help the lowest-income households. The exemption hasn't been increased in about a decade. Tripling it, as the Governor recommends, means a family of four earning up to nearly \$60,000 would realize an income tax cut, even in the context of the overall tax increase.
- Some policymakers have raised questions about the approximately \$2 billion cost of tripling the exemption, and its lack of specifically targeting relief to the families who need help most.
- Voices believes that policymakers should keep in mind yet another tax-fairness tool, one that enjoys strong, bipartisan support and targets help to the lowest-income families: the Illinois Earned Income Tax Credit. It is available only to low- and moderate-income families; this year, for example, a family of two parents and two children, earning up to about \$42,000, can claim the credit.
- The EITC helps to offset not only income taxes but the many other taxes in which low-income families pay an unfairly high amount of their earnings – from property and sales to excise taxes. The credit is also a work support and incentive, available

only to families with employment. And it serves as a true economic stimulus, by keeping more money in the hands of the families most likely to spend it at the local level, at neighborhood stores and businesses.

- The EITC's chief hang-up is its small size: calculated at only 5 percent of the much bigger, federal EITC, our state credit is worth a maximum of about \$240 this year. Many other state EITCs are up to eight times greater than ours.
- We should raise the Illinois EITC to 20 percent of its federal counterpart, to provide low- and moderate-income families with more of the targeted tax relief they need today—and will need even more tomorrow, if we ultimately increase income, gas and/or other general taxes to help address our state deficit and other pressing problems. Such an EITC increase would cost about \$350 million more than what we spend today on the credit.
- Perhaps a combination of measures—quadrupling the EITC and doubling the exemption—is possible and desirable to increase tax fairness.