



Issue Brief

Budget & Tax Policy Initiative

June 2007

GENERATING NEW REVENUE, IMPROVING TAX FAIRNESS A POLICY STRATEGY FOR INCOME TAX REFORM IN ILLINOIS

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This issue brief proposes a policy strategy for fiscal reform that links a higher individual income tax rate to a reform package with three components: a higher personal exemption, which would benefit all households and would make the state income tax structure more progressive; a more generous state earned income tax credit targeted at the working poor; and a child tax credit to provide additional relief for both low-income and middle-income families. The issue brief outlines three alternative tax reform plans and presents estimates of changes in tax liability for families at different income levels, as well as estimates of new state revenue that would be generated under each plan.

Three months ago, Governor Rod Blagojevich submitted to the Illinois General Assembly an ambitious budget for FY 2008 that included major initiatives for education funding and access to health care, as well as a plan for sounder financing of the state's pension systems. The principal source of revenue for these initiatives was a new gross receipts tax (GRT) on nearly all business transactions in the state. The GRT was designed to generate \$7.6 billion by FY 2009. In mid-May, the House of Representatives overwhelmingly rejected the Governor's GRT plan. Since then, there has been no agreement on a viable alternative for generating revenue to meet the needs of children, families, and communities in Illinois.

Voices for Illinois Children strongly endorses the major spending priorities in the Governor's proposed budget.¹ For most of the spring legislative session, however, the budget debate has narrowly focused on the revenue side and has been framed as a stark choice between supporting or opposing the GRT. The preoccupation with a GRT and the ensuing political stalemate have impeded serious consideration of policies for improving education, expanding access to health care, and strengthening human services. The fundamental fiscal problem in Illinois is two-fold: (1) generating revenue to meet the state's ongoing obligations and emerging challenges, and (2) making the state and local revenue system more equitable.

The Governor and most legislators have conspicuously avoided the logical starting point on a path to fiscal reform — the state income tax. This issue brief outlines a policy strategy that would link a higher individual income tax rate to a reform package with three components: raising the personal exemption, increasing the state earned income tax credit, and instituting a child tax credit. Taken together, these relatively straightforward changes would enable the state to make progress toward the goals of generating new revenue and enhancing tax fairness.

¹ For an analysis of the Governor's budget proposal, see Voices for Illinois Children, 2007.

TAX FAIRNESS

Public finance analysts think about tax fairness in terms of two dimensions: “horizontal equity” and “vertical equity.” *Horizontal equity* is based on the idea of an “even playing field.” Those in the same economic circumstances should pay the same amount of taxes. In this regard, taxing different sources of income at different rates (e.g., earnings and capital gains at the federal level) can be considered a violation of the principle of horizontal equity. Similarly, horizontal equity is weakened by special tax breaks for particular groups of individuals or businesses.

Vertical equity involves the notion of “ability to pay.” Those with greater economic resources should pay more taxes. A “regressive” tax, which places a higher relative burden on those with less ability to pay, is contrary to the principle of vertical equity. The sales tax, for example, is generally regarded as regressive because poorer households spend a larger proportion of their incomes than do wealthier households. Vertical equity requires that income taxes be at least proportional; that is, the amount of tax paid should be proportional to one’s total income. Many people believe that income tax policies should go beyond simple proportionality and be made “progressive,” which means that the relative tax burden increases with ability to pay. There is often disagreement, however, about the forms and degrees of progressivity that are necessary for vertical equity. The progressivity of income taxes is generally associated with graduated rate structures, but vertical equity can also be enhanced with standard deductions and personal exemptions, which establish thresholds for taxable income, as well as with targeted tax credits.

THE ILLINOIS INCOME TAX

The Illinois constitution requires that any state income tax have non-graduated rates. Since 1989, the state has had an individual rate of 3 percent, the lowest flat rate among the 41 states that have income taxes. In the Midwest, flat rates are used in Indiana (3.4%) and Michigan (3.9%), while five other states have graduated income taxes with top rates ranging from 6 percent in Missouri to 8.98 percent in Iowa (see Table 1).

The Illinois income tax, with its low taxable income threshold and flat tax rate, is one of the least progressive state income taxes in the nation.

With no standard deduction and a \$2,000 personal exemption for each family member, Illinois also has a relatively low taxable income threshold (i.e., the income level at which taxation begins). Among other midwestern states, for example, both Minnesota and Missouri use the federal standard deduction, which is adjusted annually for inflation. In tax year 2006, the standard deduction was \$10,300 for a married couple and \$7,550 for a single head-of-household. Michigan has no standard deduction but uses the federal personal exemption, which was \$3,300 in 2006 (also indexed to inflation). Wisconsin has a standard deduction that is both indexed to inflation and graduated. For a married couple in 2006, the standard deduction began at \$15,240 and gradually declined to zero when household income exceeded \$94,175 (see Table 1).

As a result of its combination of a low taxable income threshold and a flat tax rate, Illinois has one of the least progressive income taxes in the nation, and it puts a relatively high tax burden on low-income families. However, the overall individual income tax burden in Illinois is quite low. In fiscal year 2005, income taxes per capita were lowest in the Midwest and 24 percent below the nationwide average. As a proportion of personal income, Illinois income taxes were again lowest in the Midwest and 27 percent below the U.S. average (see Table 2).

Table 1: Individual Income Taxes, Midwestern States, Tax Year 2006

	Bottom rate	Top rate	Top bracket		Standard deduction		Personal exemption
			Married filing jointly	Single head of household	Married filing jointly	Single head of household	
Illinois	3.00	---	-----	-----	-----	-----	2,000
Indiana	3.40	---	-----	-----	-----	-----	1,000
Iowa	0.36	8.98	58,500	58,500	4,060	4,060	-----
Michigan	3.90	---	-----	-----	-----	-----	3,300
Minnesota	5.35	7.85	119,111	101,451	10,300	7,550	3,300
Missouri*	1.50	6.00	9,001	9,001	10,300	7,550	2,100
Ohio	0.65	6.87	200,001	200,001	-----	-----	1,400
Wisconsin*	4.60	6.75	183,210	137,411	15,240	10,930	700

* In Missouri, the personal exemption for children is \$1,200. In Wisconsin, the standard deduction is phased out at higher income levels.

Sources: Tax Policy Center <www.taxpolicycenter.org> and Federation of Tax Administrators <www.taxadmin.org>.

Table 2: State and Local Revenue from Individual Income Taxes, Midwestern States, FY 2005

	Per capita	Index*	Per \$1,000 of personal income	Index*
Illinois	\$638	76	\$17.14	73
Indiana	790	95	24.63	104
Iowa	808	97	24.63	104
Michigan	665	80	19.81	84
Minnesota	1,271	152	33.17	141
Missouri	767	92	23.85	101
Ohio	1,172	140	35.79	152
Wisconsin	1,017	122	29.71	126
U.S. total	835	100	23.57	100

* As percentage of U.S. average

Source: U.S. Bureau of the Census <www.census.gov>.

REFORMING THE STATE INCOME TAX

In recent fiscal debates, legitimate concerns have been raised about turning to the individual income tax for additional revenue — in particular, how to avoid putting an undue burden on low- and middle-income working families. The individual income tax can, however, be made relatively more progressive, even within the constraints of the state constitution. This objective can be achieved through a tax reform package consisting of a higher personal exemption, a more generous earned income tax credit, and a state version of the federal child tax credit.

Raising the Personal Exemption

Since the enactment of the state income tax in 1969, the real value of the personal exemption has significantly eroded. In 1970, the personal exemption was \$1,000. For a family of four, exemptions amounted to \$4,000, which was the same as the federal poverty level (FPL) for a two-parent family with two children. Twenty-five years later, with the personal exemption at the same nominal level, exemptions for a family of four totaled only 26 percent of FPL. Between 1998 and 2000, the personal exemption was gradually increased to \$2,000. Nonetheless, in 2006, exemptions for a family of four were less than 40 percent of FPL (see Table 3).

Raising the personal exemption would benefit all households, but its relative value would be greatest for those at lower income levels.

Any increase in the individual income tax rate should be linked to a higher personal exemption that is also indexed to inflation. A higher personal exemption would benefit all households, but its relative value would be greatest for those at lower income levels. The overall tax structure would be more progressive — without graduated rates.²

An additional reason for using the personal exemption as a tool for tax fairness is its simplicity, which is one of the virtues of the income tax system in Illinois. The personal exemption is readily understood by taxpayers and easy for state government to administer. Raising the personal exemption would not require any major changes in the state income tax form.

Table 3: Personal Exemptions for State Income Tax in Illinois

	1970	1995	2006
Personal exemptions for family of four	\$4,000	\$4,000	\$8,000
Poverty level for family of four with two children	\$3,968	\$15,455	\$20,444
Personal exemptions as pct. of federal poverty level	101%	26%	39%

² Several recent proposals for raising the state income tax do not include provisions for a higher personal exemption. See Civic Committee, 2006; Civic Federation, 2007; Center for Tax and Budget Accountability, 2007.

Increasing the State Earned Income Tax Credit

The federal earned income tax credit (EITC), first enacted in 1975, was originally designed to offset Social Security payroll taxes and strengthen work incentives for low-income families with children. The EITC has since expanded into an extremely important policy tool to supplement the earnings of low-wage workers. A distinctive feature of the EITC is that it is “refundable.” That is, if the amount of the credit for a given family exceeds their income tax liability, the Internal Revenue Service will refund the difference.

The state earned income tax credit in Illinois is currently set at 5 percent of the federal EITC. Among the states that base their EITCs on the federal EITC, none offers a smaller credit.

EITC eligibility limits and tax credit amounts are adjusted annually for inflation. In tax year 2006, the amount of the credit peaked at \$4,536 for a single parent with earnings between \$11,300 and \$14,850 and for a married couple with earnings between \$11,300 and \$16,850. At higher income levels, the credit was gradually reduced, ending at earnings of \$36,350 for a single parent and \$38,348 for a married couple (see Table 4).

Many states have adopted their own versions of the EITC. The state EITC in Illinois is currently set at 5 percent of the federal tax credit. Among the 18 states that base their EITCs on the federal EITC, none offers a smaller credit. By contrast, EITCs as a proportion of the federal credit are substantially higher in Kansas (15%), Delaware (20%), Rhode Island (25%), New York (30%), Vermont (32%), and several other states.³ Increasing the Illinois EITC (a refundable credit) would provide additional tax relief for those who need it most — the working poor.

Table 4: Federal and State Earned Income Tax Credits, Tax Year 2006

Earned income	Federal EITC				Illinois EITC			
	Single head of household		Married filing jointly		Single head of household		Married filing jointly	
	One child	Two or more children	One child	Two or more children	One child	Two or more children	One child	Two or more children
\$10,000	\$2,747	\$4,010	\$2,747	\$4,010	\$137	\$201	\$137	\$201
15,000	2,713	4,491	2,747	4,536	136	225	137	227
20,000	1,914	3,438	2,233	3,859	96	172	112	193
25,000	1,115	2,385	1,434	2,806	56	119	72	140
30,000	316	1,332	635	1,753	16	67	32	88
35,000	0	279	0	700	0	14	0	35
40,000	0	0	0	0	0	0	0	0

³ Okwuje and Johnson, 2006.

Establishing a Child Tax Credit

The federal child tax credit (CTC), instituted as part of the Taxpayer Relief Act of 1997 and expanded in 2001 and 2003, is targeted more broadly than the EITC. Families with taxable earnings above \$11,300 can receive a credit of up to \$1,000 per qualifying child under age 17.

The CTC is phased out beginning at the \$110,000 income level for married couples filing jointly and at \$75,000 for single heads-of-household (see Table 5). In contrast to the EITC, the child tax credit is only partially refundable and is not automatically adjusted for inflation. In 2005, CTC benefits totaled \$46 billion, with about two-thirds going to families with incomes above \$40,000.⁴

If Illinois adopted a state version of the federal child tax credit, it could provide significant tax relief to both low-income and middle-income families.

If Illinois were to adopt a state version of the child tax credit, it could provide significant tax relief to both middle-income and low-income families — those with incomes too high to qualify for or significantly benefit from the EITC. The child tax credit has several other advantages in comparison to the EITC. Under the CTC, single-parent households receive the same credit per child as two-parent households, and all eligible families can receive additional credits for more than two children. Like the EITC, a state child tax credit linked to the federal CTC would be simple to administer. Although the federal CTC is not indexed to inflation, the state could make its own annual adjustments.

Table 5: Federal Child Tax Credit, Tax Year 2006

Single head-of-household			Married filing jointly		
Earned income	One child	Two children	Earned income	One child	Two children
\$10,000	0	0	\$10,000	0	0
15,000	641	555	15,000	555	555
20,000	1,000	1,561	20,000	1,000	1,305
25,000	1,000	2,000	25,000	1,000	2,000
50,000	1,000	2,000	50,000	1,000	2,000
75,000	1,000	2,000	75,000	1,000	2,000
85,000	500	1,500	110,000	1,000	2,000
95,000	0	1,000	115,000	750	1,750
100,000	0	750	130,000	250	1,000
110,000	0	250	140,000	0	500
115,000	0	0	150,000	0	0

⁴ Burman and Wheaton, 2005.

EFFECTS OF INCOME TAX REFORM PLANS ON FAMILIES

To illustrate the cumulative impact of the reforms outlined above, this section presents estimated changes in state income tax liability under three different plans. Reform Plan A would raise the individual income tax rate to 5 percent and the personal exemption to \$4,500. Plan B involves a 4.5 percent rate and a \$4,000 exemption. Plan C sets the tax rate at 4 percent and the personal exemption at \$3,500. Each plan also includes a different combination of an increased state EITC and a new state child tax credit (see Table 6).

	<i>Reform Plan A</i>	<i>Reform Plan B</i>	<i>Reform Plan C</i>
Income tax rate	5.0%	4.5%	4.0%
Personal exemption	\$4,500	\$4,000	\$3,500
State EITC	20% of federal	15% of federal	10% of federal
State child tax credit	30% of federal	25% of federal	20% of federal

Married couples with two children

Table 7 shows the effects of each tax reform plan on married-couple families with two children at various income levels. The income categories are also expressed as a percentages of the federal poverty level. At any given income level, tax liabilities would be higher for corresponding families with one child and lower for families with three children.⁵

Under each tax reform plan, the tax liability for a family of four with two children and an income of \$60,000 (close to the median family income in Illinois) would be smaller than it is now.

- *\$20,000 income level:* Families of four with incomes of \$20,000 (just below 100% of FPL) currently pay \$167 in Illinois income taxes after accounting for the state EITC. Under all three reform plans, these families would benefit from a higher personal exemption, a higher EITC, and a partial child tax credit. They would have no state income tax liability and would be eligible for a refundable tax credit.
- *\$40,000 income level:* Families with incomes near 200% of FPL would not be eligible for the EITC but would benefit from both a higher personal exemption and the CTC. Under all three reform plans, these families would pay substantially less than they do now. A married couple with two children would have their taxes reduced by \$520 under Plan A, \$380 under Plan B, and \$320 under Plan C.
- *\$60,000 income level:* A family of four with two children and an income of about \$60,000 (close to the median family income in Illinois) would still be

⁵ For married couples filing jointly, the “break even” point (i.e., the income level at which their tax liabilities would be about the same under the current system and the reform plans) is in the range of \$40,000-45,000 with one child, \$60,000-70,000 with two children, and \$85,000-100,000 with three children.

eligible for the CTC. Under each reform plan, they would pay slightly less than they do under the current system.

- *\$80,000 income level:* These families of four (at about 400% of FPL), benefiting from a higher personal exemption and the new CTC, would see modest increases in their state income taxes — between \$6 and \$25 per month.

At higher income levels, the increased state tax liability would be partially offset for families that itemize deductions on their federal income tax returns. (More than 90% of tax filers with incomes at or above \$100,000 take itemized deductions.) Under Plan A, for example, a married couple with two children and an income of \$100,000 would have their state income taxes increased by \$740. Assuming a 25 percent federal tax bracket, this amount would be reduced to \$555 after accounting for itemized deductions.

Single parents with two children

Table 8 shows estimated changes in income tax liability for single-parent families with two children. The income categories differ from those for married couples to reflect the lower average earnings of single-parent households, as well as the fact that the data are for families of three.

- *\$16,000 income level:* A single-parent family with an income of \$16,000 (just below 100% of FPL) would be eligible for a large EITC and a partial CTC. They have no state income tax liability and would receive a refundable tax credit.

- *\$32,000 income level:* Single-parent families with two children at about 200 percent of FPL would be eligible for a smaller EITC and a full CTC. These families would pay substantially less income tax than they do now. Single parents with two children would have their taxes reduced by \$592 under Plan A, \$471 under Plan B, and \$366 under Plan C.

- *\$48,000 income level:* At this income level, single parents with two children would still be eligible for the CTC but not the EITC. Under all three reform plans, these families would pay slightly less than they do now.

- *\$64,000 income level:* Families of three with incomes near 400 percent of FPL would benefit from a higher personal exemption as well as the child tax credit. Under Plan A and Plan B, they would have small increases in their state income tax liability — between \$8 and \$15 per month. Under Plan C, their taxes would be the same as under the current system.

- *\$80,000 income level:* These single-parent families would be eligible for a partial CTC and would have modest income tax increases, ranging from \$17 to \$48 per month, depending on the reform plan.

Table 7: Changes in State Income Tax Liability for Married Couple with Two Children

	Earned income (Percentage of federal poverty level)				
	\$20,000 (98%)	\$40,000 (196%)	\$60,000 (293%)	\$80,000 (391%)	\$100,000 (489%)
<i>Current system</i>					
Personal exemption at \$2,000	-\$8,000	-\$8,000	-\$8,000	-\$8,000	-\$8,000
Net taxable income	12,000	32,000	52,000	72,000	92,000
Tax rate at 3%	360	960	1,560	2,160	2,760
State EITC at 5% of federal EITC	-193	0	0	0	0
Current tax liability	167	960	1,560	2,160	2,760
<i>Reform Plan A</i>					
Personal exemption at \$4,500	-18,000	-18,000	-18,000	-18,000	-18,000
Net taxable income	2,000	22,000	42,000	62,000	82,000
Tax rate at 5%	100	1,100	2,100	3,100	4,100
State EITC at 20% of federal EITC	-772	0	0	0	0
State CTC at 30% of federal CTC	-392	-600	-600	-600	-600
New tax liability	-1,063	500	1,500	2,500	3,500
Change in tax liability	-1,230	-460	-60	340	740
With federal deduction*	-----	-----	-----	289	555
<i>Reform Plan B</i>					
Personal exemption at \$4,000	-16,000	-16,000	-16,000	-16,000	-16,000
Net taxable income	4,000	24,000	44,000	64,000	84,000
Tax rate at 4.5%	180	1,080	1,980	2,880	3,780
State EITC at 15% of federal EITC	-579	0	0	0	0
State CTC at 25% of federal CTC	-326	-500	-500	-500	-500
New tax liability	-725	580	1,480	2,380	3,280
Change in tax liability	-892	-380	-80	220	520
With federal deduction*	-----	-----	-----	187	390
<i>Reform Plan C</i>					
Personal exemption at \$3,500	-14,000	-14,000	-14,000	-14,000	-14,000
Net taxable income	6,000	26,000	46,000	66,000	86,000
Tax rate at 4%	240	1,040	1,840	2,640	3,440
State EITC at 10% of federal EITC	-772	0	0	0	0
State CTC at 20% of federal CTC	-261	-440	-440	-440	-440
New tax liability	-407	640	1,440	2,240	3,040
Change in tax liability	-574	-320	-120	80	280
With federal deduction*	-----	-----	-----	68	210

* Assumes 15% tax bracket for family with \$80,000 income and 25% bracket for family with \$100,000 income.

Note: Estimates are based on income and poverty levels for 2006. Tax liabilities do not include adjustments for property tax credits or education expense credits.

Table 8: Changes in State Income Tax Liability for Single Parent with Two Children

	Earned income (Percentage of federal poverty level)				
	\$16,000 (99%)	\$32,000 (197%)	\$48,000 (296%)	\$64,000 (394%)	\$80,000 (493%)
<i>Current system</i>					
Personal exemption at \$2,000	-\$6,000	-\$6,000	-\$6,000	-\$6,000	-\$6,000
Net taxable income	10,000	26,000	42,000	58,000	74,000
Tax rate at 3%	300	780	1,260	1,740	2,220
State EITC at 5% of federal EITC	-214	-46	0	0	0
Current tax liability	86	734	1,260	1,740	2,220
<i>Reform Plan A</i>					
Personal exemption at \$4,500	-13,500	-13,500	-13,500	-13,500	-13,500
Net taxable income	2,500	18,500	34,500	50,500	66,500
Tax rate at 5%	125	925	1,725	2,525	3,325
State EITC at 20% of federal EITC	-856	-182	0	0	0
State CTC at 30% of federal CTC	-212	-600	-600	-600	-525
New tax liability	-943	143	1,125	1,925	2,800
Change in tax liability	-1,029	-592	-135	185	580
With federal deduction*	-----	-----	-----	157	493
<i>Reform Plan B</i>					
Personal exemption at \$4,000	-12,000	-12,000	-12,000	-12,000	-12,000
Net taxable income	4,000	20,000	36,000	52,000	68,000
Tax rate at 4.5%	180	900	1,620	2,340	3,060
State EITC at 15% of federal EITC	-642	-137	0	0	0
State CTC at 25% of federal CTC	-176	-500	-500	-500	-438
New tax liability	-638	263	1,120	1,840	2,623
Change in tax liability	-724	-471	-140	100	403
With federal deduction*	-----	-----	-----	85	343
<i>Reform Plan C</i>					
Personal exemption at \$3,500	-10,500	-10,500	-10,500	-10,500	-10,500
Net taxable income	5,500	21,500	37,500	53,500	69,500
Tax rate at 4%	220	860	1,500	2,140	2,780
State EITC at 10% of federal EITC	-428	-91	0	0	0
State CTC at 20% of federal CTC	-141	-400	-400	-400	-350
New tax liability	-349	369	1,100	1,740	2,430
Change in tax liability	-435	-366	-160	0	210
With federal deduction*	-----	-----	-----	-----	179

* Assumes 15% tax bracket for family with \$64,000 income and for family with \$80,000 income.

Note: Estimates are based on income and poverty levels for 2006. Tax liabilities do not include adjustments for property tax credits or education expense credits.

More Progressivity without Graduated Rates

The combined effects of tax rates, personal exemptions, and targeted tax credits illustrate how the income tax system can be made more progressive without graduated rates. In Plan A, the highest tax rate (5%) is combined with the largest personal exemption, EITC, and CTC. By contrast, Plan C has the lowest rate (4%) and the smallest set of tax offsets. For low-income families, especially those that benefit from both the EITC and the CTC, the effects of tax offsets are dominant; their tax liabilities are *lowest* under Plan A. For upper-income families, especially those that are not eligible for the CTC and benefit only from the personal exemption, the effects of increased tax rates are dominant; their tax liabilities are *highest* under Plan A. In sum, Plan A introduces relatively more progressivity at both the lower and upper segments of the income distribution.

REVENUE ESTIMATES FOR ALTERNATIVE TAX REFORM PLANS

Table 9 presents FY 2009 revenue estimates for three different income tax reform plans. Under each plan, the corporate income tax rate would be raised in proportion to the individual rate.⁶ Plan A would raise the individual income tax rate to 5 percent and the personal exemption to \$4,500. After adjustments for the higher exemption, as well as the EITC and CTC, net additional income tax revenue would be about \$5 billion. Raising the corporate income tax to 8 percent would bring total new revenue to \$6.1 billion. Under Plan B, which has a 4.5 percent individual income tax rate and a 7.2 percent corporate rate, the net revenue yielded by income taxes would be about \$4.6 billion. Plan C includes an individual rate of 4.0 percent and a personal exemption of about \$3,500. With the corporate income tax raised to 6.4 percent, Plan C would generate about \$3 billion in new state revenue. Although the table contains estimates for one fiscal year, any of the three revenue plans could be phased in over several years.

Table 9: Estimates of State Revenue under Alternative Income Tax Reform Plans, FY 2009 (\$ millions)

<i>Reform Plan A</i>		<i>Reform Plan B</i>		<i>Reform Plan C</i>	
Individual rate: 5.0%	\$7,164	Individual rate: 4.5%	\$5,371	Individual rate: 4.0%	\$3,578
Exemption: \$4,500	-1,479	Exemption: \$4,000	-1,063	Exemption: \$3,500	-707
EITC: 20% of federal	-240	EITC: 15% of federal	-160	EITC: 10% of federal	-80
CTC: 30% of federal	-450	CTC 25% of federal	-375	CTC: 20% of federal	-300
Net: indiv. income tax	4,995	Net: indiv. income tax	3,773	Net: indiv. income tax	2,491
Corporate rate: 8.0%	1,127	Corporate rate: 7.2%	845	Corporate rate: 6.4%	563
New state revenue	6,122	New state revenue	4,618	New state revenue	3,054

Note: Estimates based on data and projections from Illinois Office of the Comptroller, Illinois Department of Revenue, and Commission on Government Forecasting and Accountability.

⁶ The state constitution stipulates that the ratio between corporate and individual income tax rates be no greater than 8 to 5. The revenue estimates in Table 9 do not include adjustments for the package of corporate “tax loophole” closings passed by the General Assembly at the end of May. For discussions of reform options for the corporate income tax in Illinois, see Calbalquinto et al., 2006, pp. 22-25; McNichol and Lav, 2007, p. 11.

The income tax reform plans outlined here are not the only possibilities, of course.⁷ The balance between generating new revenue and improving tax fairness can be drawn in various ways. Based on the FY 2009 estimates in Table 9, each half-point increase in the individual income tax rate generates about \$1.8 billion. Tax rates also determine the revenue effects of changes in the personal exemption. With a rate of 5 percent, the cost of raising the personal exemption by \$500 would be \$296 million. At a 4 percent tax rate, the corresponding revenue loss would be \$236 million. By contrast, the revenue effects of the EITC and the child tax credit are independent of the tax rate. For FY 2009, it would cost the state about \$80 million to increase its EITC from 5 percent to 10 percent of the federal EITC. The total value of the federal child tax credit for Illinois residents is about \$1.5 billion, so a state CTC at 20 percent of the federal CTC would cost about \$300 million.

OTHER REVENUE OPTIONS

An income tax reform plan could be combined with other revenue options. Some legislators support a proposal to extend the state sales tax to a specified set of services. Broadening the base of the sales tax could generate a substantial amount of new revenue in the short run and would make the sales tax more responsive to economic growth in the long run. In addition, a broader base is certainly consistent with principles of horizontal equity. Insofar as services are excluded from the tax base, two households with the same incomes pay different amounts of sales tax, depending on the mix of goods and services in their household spending. The impact of taxing services on vertical equity is less clear. Although some services are consumed disproportionately by more affluent households — for example, dry cleaning, landscaping and lawn care, interior design, automobile leasing, golf and country clubs, travel services, swimming pool cleaning services, health clubs — many other services are not. The implications for vertical equity will depend on which services are subject to the sales tax, although available research suggests that the overall distributional impact is likely to be limited.⁸

Another supplemental revenue source could be a gross receipts tax that is much smaller than the one proposed by the Governor. Concerns raised by critics of the GRT include its impact on businesses with small profit-margins, the potential tax burden passed onto consumers, and the cumulative effects of imposing the same tax on multiple stages of the production process (i.e., “pyramiding”). These concerns were magnified by the size of the GRT suggested for Illinois (\$7.6 billion for FY 2009). The proposed GRT rates — 1 percent on goods and 2 percent on services in the latest version — are considerably higher than those in other states with similar taxes. In the state of Washington, for example, the rates are 1.5 percent for services and under 0.5 percent for manufacturing, wholesale, and retail firms. Any revival of the GRT idea in Illinois would have to involve significantly lower rates.⁹

One policy option that we do not recommend is casino gambling. Turning to new riverboat or land-based casinos or to expansion of existing casinos as revenue solutions would not be sound fiscal policy. Public promotion of legalized gambling, which amounts to regressive “back door”

⁷ The Metropolitan Planning Council has proposed a plan with a 5 percent income tax rate and a \$4,000 personal exemption. See Goldstein, 2007.

⁸ Mazerov, 2003.

⁹ Lower GRT rates might be combined with other modifications such as allowing businesses to subtract the cost of purchased inputs from their tax base, exempting retail transactions already covered by the state sales tax, or providing some form of standard deduction for all businesses. On subtracting the cost of purchased inputs from the GRT base, see McNichol and Lav, 2007.

taxation, exacerbates social problems with adverse impacts on families and children. There is evidence, for example, that casino gambling is associated with higher rates of personal bankruptcy in surrounding communities.¹⁰ Moreover, this kind of quick fix cannot provide a stable or adequate revenue source for state government.¹¹

CONCLUSION

The Illinois income tax can be made more progressive without trying to amend the state constitution. Likewise, it is possible to generate more revenue from the individual income tax without putting a heavy burden on low-income and middle-income families. The key is developing a tax reform plan that includes the kinds of measures discussed in this issue brief. Any income tax increase should be accompanied by a higher personal exemption (indexed to inflation), which would benefit all households and would improve vertical equity in the state's revenue system. In addition, the state should increase its earned income tax credit to supplement the wages of the working poor and should establish a child tax credit to provide additional relief for both low-income and middle-income families. This policy strategy offers a clear and sustainable path to the elusive goals of tax fairness and adequate revenues that are needed for improvements in education, health care, and human services for children and families in Illinois.

More revenue can be generated from the individual income tax without putting a heavy burden on low-income and middle-income families.

The fiscal problems of state and local government in Illinois — chronic state budget deficits, heavy reliance on local property taxes, inadequate and inequitable funding of public schools, an income tax system with minimal progressivity — are hardly new.¹² Growing recognition of these problems has not, however, been matched by the political will to confront them. While the onset of “extra innings” in a state legislative session does not inspire public confidence, it does present another window of opportunity for fiscal reform. To paraphrase Yogi Berra, it isn't over until it's over.

¹⁰ Nichols, Stitt, and Giacompassi, 2000; Barron, Staten, and Wilshusen, 2002; Morse and Goss, 2007.

¹¹ Voices for Illinois Children, 2004.

¹² See, e.g., Joseph, 1996.

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This issue brief was prepared as a part of the Budget & Tax Policy Initiative at Voices for Illinois Children. To promote discussion of the information and analysis presented here, we encourage readers to make copies of the brief and to disseminate it. We are grateful to the Advisory Committee of the Budget & Tax Policy Initiative and to the Center on Budget and Policy Priorities for their comments and suggestions.

About Voices for Illinois Children

Voices for Illinois Children works across all issue areas to improve the lives of children of all ages throughout our state so they grow up healthy, happy, safe, loved and well educated. For 20 years, Voices has been helping opinion leaders and policymakers understand the issues facing children and families. The Voices network weaves through the state, involving community leaders and people who care passionately about children. Jerome Stermer is President of Voices for Illinois Children, and Craig R. Culbertson is Chair of the Board of Directors.

About the Budget & Tax Policy Initiative

The Budget & Tax Policy Initiative provides information and analysis to advocates and policymakers on a wide range of spending and revenue topics that have direct impact on the lives of children and families in Illinois. The Initiative helps Illinois policymakers and advocates set priorities and make wise fiscal decisions for the short term and for the long haul.

The Budget & Tax Policy Initiative is funded by the Ford Foundation, the Annie E. Casey Foundation, and the Chicago Community Trust. We thank them for their support but note that the findings and conclusions presented here are those of Voices for Illinois Children alone and do not necessarily reflect the views of these foundations.

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