



Issue Brief

Budget & Tax Policy Initiative



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POLICY UPDATE

THE STATE BUDGET CRISIS AND INCOME TAX REFORM

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As the state budget stalemate reaches a crisis level, a modest income tax increase has emerged as one proposed solution. Governor Blagojevich has repeated his opposition to any income tax increase, which he considers an unfair burden on working families. But an *income tax reform* strategy could actually generate new revenue and improve tax fairness at the same time. The General Assembly and the Governor should support a revenue plan linking a modest income tax increase with a set of reforms that would make the overall tax structure more progressive.

Increase the personal exemption: When the state income tax was first enacted in 1969, the personal exemption was \$1,000, which would be equivalent to more than \$5,000 in today's currency. Any increase in the income tax should be accompanied by a higher exemption that is also indexed to inflation. Substantially raising the personal exemption (now \$2,000 — or \$8,000 for a family of four) would benefit all households, but its impact would be greatest for those at lower income levels.

Expand the state earned income tax credit (EITC): The federal EITC is an important policy tool for supplementing the wages of low-income families with children. The income eligibility limit is near \$40,000, although the amount of the credit is highest for those with earnings in the range of \$12,000-\$17,000 and then is gradually reduced. The state EITC in Illinois — currently set at 5% of the federal EITC — is one of the smallest such credits in the nation. More than two-thirds of state EITCs based on the federal credit are set at 10% or higher.

Adopt a state child tax credit (CTC): Working families with earnings above \$11,750 are eligible for the federal CTC, which offers up to \$1,000 for each qualifying child under age 17. Eligibility is phased out beginning at \$110,000 for married couples and \$75,000 for single heads-of-household. In contrast to the EITC, single-parent and two-parent households receive the same credit per child, and families can get additional credits for more than two children.

* For more detailed background and analysis, see *Generating New Revenue, Improving Tax Fairness: A Policy Strategy for Income Tax Reform in Illinois* (June 2007) <www.voices4kids.org/library/files/BTO7_incometax.pdf>.

Raising the income tax from 3% to 4% could be combined with the following reform package:

- a personal exemption of \$3,500
- a state earned income tax credit set at 10% of the federal EITC
- a state child tax credit set at 10% of the federal CTC

Table 1 shows the effects of this revenue plan on married couples with two children:

- A family with earnings of \$30,000 (about 150% of the federal poverty level) currently has a state income tax income liability of \$160 (after a \$200 offset for the state EITC). A tax rate of 4% would increase their payments by \$120, but under the tax reform package, they would get a substantial *tax cut* (\$451).
- For a comparable family of four with an income of \$50,000 (near the median household income in Illinois), the 4% rate alone would mean a \$420 tax increase. Under the reform plan, however, their tax liability would be about the same as under the current system.
- At the \$80,000 income level, the 4% tax rate would result in a tax increase of \$720 without the reform package and only \$280 (less than \$25 per month) with the reform package. At higher income levels, the increased state tax liability would be partially offset for families that itemize deductions on their federal income tax returns.

Table 1: Estimated Changes in State Income Tax Liability

Earned income for married couple with two children	Current income tax liability	Change in tax liability	
		4% rate without tax reform package	4% rate with tax reform package*
\$20,000	\$160	\$120	-\$451
30,000	569	220	-312
40,000	960	320	-120
50,000	1,260	420	-20
60,000	1,560	520	80
80,000	2,160	720	280
100,000	2,760	920	480
120,000	3,360	1,120	730
150,000	4,260	1,420	1,180

* Personal exemption at \$3,500, state EITC at 10% of federal EITC, state child tax credit at 10% of federal CTC.

Table 2 presents estimates of new state revenue in fiscal year 2009 under an individual income tax rate of 4% — with and without offsets from a higher personal exemption, an expanded state EITC, and a state child tax credit. Net revenue with the 4% rate and the tax reform package would be about \$2.7 billion. A corresponding increase in the corporate income tax (a 6.4% rate) would bring total new state revenue to \$3.4 billion. If the same tax reform package were combined with slightly higher tax rates (4.25% and 6.8%), the total amount of new revenue would be \$4.4 billion — about the same as the revenue generated by the smaller increases in tax rates without any offsets.

These estimates assume that a tax reform plan would take effect in January 2008. An income tax increase with a phase-in period of several years could be accompanied by incremental changes in the personal exemption and the targeted tax credits.

Table 2: Estimates of New State Revenue in Fiscal Year 2009 (in \$ millions)

	4% rate without tax reform offsets	4% rate with tax reform offsets	4.25% rate with tax reform offsets
Higher individual income tax rate	\$3,700	\$3,700	4,600
Personal exemption at \$3,500	-----	-725	-800
Earned income tax credit at 10% of federal	-----	-85	-85
Child tax credit at 10% of federal CTC	-----	-150	-150
Net revenue from individual income tax	3,700	2,740	3,565
Additional revenue from corporate income tax*	660	660	825
Total new state revenue	4,360	3,400	4,390

* Corporate rate at 6.4% with individual rate at 4%; corporate rate at 6.8% with individual rate at 4.25%.

The key fiscal challenge in Illinois is how to raise enough revenue to meet the state’s ongoing obligations and emerging needs without putting an unfair burden on low- and middle-income families. Policymakers in Springfield have one last window of opportunity to salvage the legislative session by showing real leadership on the issues of fiscal responsibility and tax fairness.

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