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A Revenue-Raising Plan for Illinois

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Preface

by Max B. Sawicky

In recent years, the federal government has relegated increasing responsibility to state governments. It has accomplished this goal in some important areas, most notably the welfare reform legislation passed in 1996. States have already been required to increase expenditures on a number of fronts, with the greatest pressures resulting from growing Medicaid costs. Rising school enrollment has further strained state budgets, as has increased demand for lengthier criminal incarcerations, resulting in rapid growth in spending on corrections. Although spending demands have increased, so has state revenue. In contrast to the projected decline in federal tax revenues, combined state and local revenues increased from 9.8% to 10.8% of the gross domestic product between 1979 and 1996.

Aside from maintaining current services in such areas as health care and law enforcement, there is also the question of funding for public investment-spending on infrastructure, education, and training. Although federal funds have often been available, most public investment spending is performed by state and local governments. If there is to be more public investment, states will certainly play a central role.

Important evidence attests to the value of public investment in general economic growth, but unfortunately such investment has been declining in the United States for the past 25 years. Under the latest budget agreement passed by Congress, projections indicate

a continued decline in public investment for the foreseeable future. If the size of the workforce also declines relative to that of the population as a whole (as many expect), productivity growth spurred by public investment will be even more necessary to ensure growing standards of living.

The recent gains in the national economy are doing much to obscure these basic trends. Employment has risen and state budgets are in their best shape in years. In fact, budget surpluses have become common and have led to proposals for state tax cuts. New York has already cut its taxes, and proposals are expected in Wisconsin and elsewhere.

Unfortunately, two basic facts about these tax-cutting proposals commonly go unappreciated. One is that budgetary surpluses have been made possible by a peak in the business cycle that cannot last indefinitely. A second is that, in the long run, trends in health care and demographics will eventually place renewed pressures on state revenue systems. Tax increases inevitably will be considered and made all the more necessary if states choose to cut taxes now.

Beyond the current economic boom, therefore, lurks the question of how to best reform state revenue systems. Although state tax systems typically endure the closest scrutiny when they fail to produce sufficient revenue, they should not be spared analysis and evaluation during less dire times. In light of the budget deficits anticipated by experts in the field of state and local finance, the Economic Policy Institute commissioned five papers to address the question of how states can best revise their revenue systems. The authors of these papers do not necessarily advocate such increases. They do, however, try to describe the best way of increasing state revenues while simultaneously improving the design of state tax systems. As such, these papers provide insight on tax reform irrespective of revenue goals and could be used for guidance in either revenue-neutral reforms or to replace local tax systems.

The scale of the problem addressed in these papers is large compared to the usual preoccupations of state legislatures. This choice was deliberate. These papers mean to shed light on basic deficiencies in state tax systems, not merely suggest ways of modestly boosting revenue. The latter would be a simple exercise requiring little analysis. For the specific states examined, however, these papers provide guidance in preparing for imminent structural deficits.

It is hoped that this series, focusing on state revenue programs in Illinois, Maine, New Hampshire, New York, and Wisconsin, will help launch a constructive debate on state-level tax reform. Although some of these states are more hard-pressed to examine these issues than others, it is safe to say that, sooner or later, every state will have to grapple with these tough decisions.

Introduction

If the state of Illinois needed to raise an additional IO-12% in revenues, what would be the best way for it to do so? For the past few years, policy makers, legislators, pundits, and concerned citizens have been calling for methods to reform the financing of elementary and secondary education in Illinois, making it a propitious time for such a question. Because of Illinois' high reliance on local property taxes for school funding, the calls for reform have uniformly stressed a desire for increased state involvement. Many of the proposals being given serious consideration call for about a $2 billion increase in state spending on local schools, an increase that would equal approximately 11% of Illinois' general fund revenues of $19 billion in fiscal year 1997 (or 13% of state-source revenues of approximately $15 billion).

Thanks to a strong economic recovery, Illinois is, for the near term, in relatively good fiscal shape. But the call to increase state funds for local education comes at a time when the state is facing a structural deficit in need of attention (Giertz, McGuire, and Nowlan 1995). Like most states, Illinois is facing fast-growing expenditures in corrections, health care for the indigent, and services for children in poverty. The current revenue structure in place to finance state expenditures is ill equipped to support these fast-growing programs and fails to keep pace with the underlying growth in the economy. Changes in the *structure* of Illinois' revenue system, such as extending the sales tax base or revising income taxation, could result in a system more responsive to the economy's areas of fastest growth and provide higher future revenues. Without structural changes to the state's revenue and expenditure systems, a simple tax increase in Illinois will fail to close the anticipated gap between state expenditures and revenues. If structural reform is not made, the current system will continue to require periodic rate increases or budget austerity to deal with the state's chronic deficit problem.

The best way to raise an additional 10-12% in Illinois state revenues, while at the same time reforming the tax system, would be to:

- extend the base of the sales tax to include consumer services and food for home consumption,
- lower the statewide rate of the sales tax,
- increase significantly personal exemptions under the income tax,
- include retirement income in the income tax base, and
- increase the single rate of the personal income tax.

The Revenue System in Illinois[1]

Table 1 lists the revenue sources for Illinois' general funds in fiscal year 1996.[2] General fund revenues comprised about 64% of total state revenues (approximately $18 billion of a total $28 billion in fiscal year 1996). More than three-quarters of total general fund revenues came from three primary sources — federal aid (18.6%) the individual income tax (31.6%) and the general sales tax (26.8%). The next largest single revenue source, the corporate income tax, provided only 5.5% of total general fund revenues.

This reliance on personal income and general sales taxes is fairly typical when compared to tax systems in other states. In fiscal year 1993, Illinois raised 13.4% of total state and local general revenues

TABLE 1
Illinois General Funds Revenues, FY 1996

	Revenues (millions)	Percentage Distribution of Total Receipts
Individual income tax	$5,559	31.6%
Sales Taxes	$4,798	26.8%
Federal sources	$3,339	18.6%
Corporate income tax	$978	5.5%
Public utility taxes	$833	4.6%
Lottery fund transfers	$594	3.3%
Other fund transers	$327	1.8%
Cigarette taxes	$300	1.7%
Other taxes and fees	$254	1.4%
State gaming fund transfer	$205	1.1%
Inheritance tax	$187	1.0%
Insurance taxes and fees	$160	0.9%
Investment income	$133	0.7%
Corporate franchise taxes and fees	$101	0.6%
Liquor gallonage taxes	$58	0.3%
Total revenues	$17,936	100.0%

Source: Fiscal Focus, July 1996, Office of the Comptroller, State of llinois. The values presented here do not necessarily represent the total amount collected from each tax, only the amount going to the General Funds.

from the income tax, compared to the U.S. average of 14.7%; the sales tax provided Illinois with 14.8% of its revenue, compared to the U.S. average of 16.5%.[3]

While the average revenues raised in Illinois seem similar to those of a typical state, the way in which the two main tax sources in Illinois are structured differ markedly from many other state structures. Of the 41 states with broad-based individual income taxes, only seven, including Illinois, have flat-rate tax schedules. Only one state has a lower top rate than Illinois' single rate of 3%. In Illinois, the "zero tax amount" (the sum of the personal exemption and the standard deduction) is one of the lowest in the country. The personal exemption presently stands at $1,000, and there is no standard deduction. The combination of a flat-tax rate structure with a low "zero tax amount" renders the Illinois individual income tax one of the least progressive among those states with broad-based income taxes. The state's low flat rate of 3% suggests there is room both to generate additional revenue and to distribute the income tax burden more progressively.

Of the 45 states with general sales taxes, only five have a rate higher than Illinois' statewide rate of 6.25%. In addition to state sales taxes, local governments in Illinois (especially municipalities and counties) impose local sales taxes. Chicago's combined sales tax rate of 8.75%, for instance, is well above the basic state rate. In Illinois, the state tax base is relatively narrow because few consumer

services are taxed and food for home consumption is exempt. With services accounting for an ever-larger share of consumer spending, it is difficult to justify the continued omission of these services from the general sales tax. Exempting food from sales taxation makes little sense, either, given what a blunt instrument such a policy is for relieving the burden on low-income families. Broadening the base of Illinois' sales tax would likely improve the efficiency and responsiveness of the tax. Any resulting burden on the poor could be eliminated through changes in the income tax.

Constitutional and Legal Constraints on Taxes in Illinois

Adopted in 1970, the Illinois state constitution imposes rigid restrictions on state income taxes (both individual and corporate). The constitution's revenue article states that "a tax on or measured by income shall be at a non-graduated rate... .Any such tax imposed on corporations shall not exceed the rate imposed on individuals by more than a ratio of 8 to 5." This restrictive provision was part of a political compromise in 1970 that brought Illinois' first income tax into existence. Opponents of the income tax were persuaded to accept the tax only with constitutional protection against graduated rates and the protection of corporations from "excessive" rates.

As a result, any movement to institute graduated rates would require an amendment to the state constitution. In Illinois, such amendments can be proposed only by the Illinois General Assembly, not by citizen initiative. A proposed amendment requires a three-fifths majority in both houses to be placed on the ballot for voter consideration. For ratification, the proposed amendment must be approved by 60% of the voters casting ballots on the issue or by 50% of all the voters participating in the election. In the current political environment, such an amendment is unlikely.

The current constitutional provisions severely limit the extent to which the income tax can be made progressive. Limited progressiveness can still be achieved, however, by raising the basic personal exemption levels. Phasing out personal exemptions with income (as in the federal income code) could also make income taxes more progressive. Such an option would be, in a *de facto* sense, equivalent to graduated rates during the course of the phase-out period. This sort of revision has never been tried in Illinois, so the constitutionality has never been tested.

In addition to these constitutional limitations, the state income tax, by statute, has always been shared with local governments. One-tenth of total collected individual and corporate income tax is returned to municipalities and counties based on population. This ratio was originally one-twelfth when the income tax was first adopted in 1969 but was raised to one-tenth in the early 1990s when the state income tax rate jumped from 2.5% to 3.0% for individuals and from 4.0% to 4.8% for corporations. From a legal standpoint, there is no reason why additional increases in the state income tax rate would have to be shared with local governments, especially if the new revenues are designated for local school districts.

As for sales tax, the state constitution imposes few restrictions. With the exception of food, drugs. and most services, the state imposes a uniform rate of 6.25% on tangible goods. Eighty percent of the collected taxes (5.0 percentage points of the 6.25% rate) remain with the state, and 20% (1.25 percentage points) are returned to municipalities and counties based upon the origin of the sales. A 1% rate is im-

posed at the state level on food and drugs, with the full amount returned to local governments.

In addition to the uniform 6.25% state sales tax, the state permits various local governments (home-rule units) to impose additional local sales taxes in increments of 0.25 percentage points. For example, in the city of Chicago, the city imposes a 1.0% rate, the county imposes a rate of 0.75%, and the transportation authority imposes a 0.75% rate, resulting in a combined state and local rate of 8.75%.

Reforming the Tax Structure to Increase Revenue

The best plan for raising 10-12% more in revenues (approximately $1.9 billion) **would involve broadening** the base of the sales tax; lowering the overall sales tax rate; increasing the single rate of the income tax; eliminating the exclusion of retirement income from the income tax; and removing low-income individuals from the rolls by increasing personal exemptions.

This proposal does not advise increased state taxes on alcohol and tobacco products for three reasons. First, Illinois presently raises only a small share of total state revenues from these taxes (approximately 2%); even at extraordinarily high tax rates, the increased revenue would still be insufficient to meet the budget needs. Second, taxes on these products are highly regressive. Finally, the tax bases are not elastic, rendering this approach limited in its ability to address the structural deficit problem.

Some states rely heavily on fees and charges, but in Illinois tuition fees at public universities and colleges are low. An increase in these kinds of fees would represent a potentially good source of additional revenue, scoring well in terms of efficiency and equity. Many of these fees, however, are earmarked for certain expenditures, excluding them from use for general state spending. The only way in which an increase in these fees could be of benefit to the state would be in their ability to free up other general fund revenue sources.

Table 2 describes the current sales and individual income tax systems and the proposed alternative structures for both. The proposed change to the income tax raises the personal exemption to $4,000 (approximately the inflation-adjusted value of the $1,000 exemption enacted in 1970) and indexes the exemption to the consumer price index. The new tax base would include all forms of retirement income that are currently taxed by the federal government but not by Illinois. This proposal maintains the flat rate but raises it from 3.0% to 4.4%. These changes alone would raise an additional $1.52 billion for the state.

The proposed alternative to the sales tax extends its base to a broad array of consumer services and food for home consumption. The inclusion of consumer services in the sales tax base has a number of attractive features. Since services are a growing portion of consumer expenditures, their inclusion would make the sales tax more responsive to the economy and help slightly to reduce the regressive quality of the sales tax base. The inclusion of services and food would also allow a lower overall rate, making Illinois more competitive with its neighbors. Broadening the base in this way would allow the tax rate to fall from 6.25% to 5.00%—a drop of 20%-while raising an additional $400 million for the state. An income tax credit for low-income taxpayers to offset the sales tax is not recommended because purchases made with food stamps would continue to be exempt from the sales tax.

TABLE 2
Description of Current and Alternative Income and Sales Tax Systems

	Current System	Alternative System
Income Tax		
Tax Rate Structure	Flat 3.00%	Flat 4.40%
Value of Personal Exemption	$1,000	$4,000
Index personal exemption or inflation	No	Yes
Include retirement income in the base	No	Yes
Sales Tax		
Overall Tax Rate	6.25%	5.00%
Tax Rate on Food not for immediate consumption	1 .00%	5.00%
Tax rate on consumer services	0.00%	5.00%

Revenue Implications (millions of dollars)	Current System	Alternative System	Change
Income Tax	5,153	6,677	1,524
Sales Tax	5,635	6,037	402
Total of two taxes	10,788	12,714	1,926

This proposal emphasizes the income tax over the sales tax as the primary source of additional revenues for several reasons. First, the sales tax is limited in its potential for contributing to the equity and responsiveness of the overall tax system. Regardless of its base structure, the sales tax is a highly regressive tax. Furthermore, the Illinois sales tax rate of 6.25% is already high relative to other states, posing a problem in places like the Chicago metropolitan area, which is situated near the Wisconsin and Indiana state borders where the sales tax is only 5.0%.

Table 3 compares Illinois' current taxes to the proposed alternatives in terms of both how the resulting burden would be distributed across income classes and the potential growth rates (or responsiveness) of the taxes. The alternative income tax is slightly more responsive, as indicated by the estimated growth rate for a recent period, and more progressive, as tax burdens are reduced for taxpayers at low-income levels and increased for taxpayers with higher incomes. The proposed sales tax would be more responsive (the growth rate increases from 0.40% to 0.62%), but not necessarily more progressive than the current system in its distribution of the burden. Average tax rates increase slightly for taxpayers in the highest income categories, but they also increase for taxpayers in the lowest ones. It is important to note that the sales tax figures in Table 3 do not account for the fact that much of the spending on food at lower income levels under the proposed alternative system would be financed with food stamps. Consequently, the actual tax burden on the lowest income taxpayers under the alternative system is likely to be significantly lower than reported in Table 3.[4]

TABLE 3
Analysis of Current and Proposed Alternative Income and Sales Tax Systems

	Income Tax		Sales Tax	
	Current System	Alternative System	Current System	Alternative System
Total Revenue in 1994 (millions)	$5,153	$6,677	$5,635	$6,037
Growth Rate of Revenue 1980 to 1993 (percent)	1.56%	1.43%	0.40%	0.62%
Variability of Revenue (percent)	4.33%	4.49%	2.94%	2.61%
Average Tax Rate by Income Level				
$0 to $5,000	0.14%	0.02%	5.65%	7.94%
$5,001 to $15,000	0.71%	0.37%	3.92%	4.52%
$15,001 to $25,000	1.45%	1.24%	3.32%	3.60%
$25,001 to $50,000	2.17%	2.47%	2.63%	2.80%
$50,001 to $75,000	2.50%	3.10%	2.24%	2.38%
$75,001 to $100,000	2.54%	3.37%	2.00%	2.12%
$100,001 to $150,000	2.65%	3.66%	1.78%	1.87%
$150,001 to $500,000	2.75%	4.04%	1.27%	1.34%
More than $500,000	2.64%	4.26%	0.66%	0.70%
Average	2.35%	3.04%	2.13%	2.28%

Note: All estimates are based on the assumption that incomes and consumption patterns do not change with changes in the tax system.

The Final Analysis

Many believe that Illinois' low flat-rate income tax is crucial to maintaining the state's competitive position in attracting businesses and valued employees. Many also believe that the exemption of food for home consumption from the sales tax is crucial to relieving the burden of taxation for the poor. How do the proposed changes stand up to these concerns?

First, while this proposal raises the income tax rate from the present 3.0% to 4.4%, it remains a low rate in comparison to other states (of the 40 other states with broad-based income taxes, 38 would still have a higher top rate than Illinois). This proposal also retains the politically important single flat rate applicable to all taxpayers. Furthermore, by increasing the level of the personal exemption and indexing it to a measure of inflation, this proposed alternative also ensures that poor families will not be overburdened by the Illinois income tax. Finally, broadening the base to include all forms of retirement income currently taxable at the federal level improves the fairness of the system by treating individuals with equal incomes equitably, regardless of their income source. The inclusion of retirement income brings the Illinois personal income tax into closer coordination with the federal income tax, putting all retirement

income on a more equal footing. In fairness to those nearing retirement, any changes in the tax status of retirement income ought to be phased in slowly to allow taxpayers time to adjust.

In the end, if this proposal's recommendations are enacted, the flat tax would be preserved, the state would raise needed revenue, and its competitive position would not be harmed. But such proposals must also be evaluated on equity grounds. Not every component of this proposal is progressive. Clearly, the income tax changes would increase the progressive character of the system. The sales tax changes, however, would increase the average tax rates for higher-income taxpayers as well as for low-income taxpayers. The actual dollar impact of the sales tax for the low-income group would be small, buffered by the exemption of purchases made with food stamps. The ultimate equity consideration, however, is whether this increased state revenue will be invested in a way that leaves low-income families better off when the impacts of state government expenditure programs are taken into account. Such a consideration wholly depends on how the state chooses to use the new tax revenues. It should be noted that state expenditure programs are, in general, much more progressive than state taxes. More than likely, any small increase in the tax burden resulting from these changes for the poor would be more than offset by better-funded state expenditure programs.

As for the sales tax, the changing nature of consumer spending argues strongly for including services in the tax base. Nor should food for home consumption be exempted. Although these taxes would result in higher burdens on low-income families relative to high-income families, the current exemption is an inexact and costly instrument for addressing these concerns. As it now stands, all consumers, regardless of income or type of food purchase, receive this exemption. A better solution would be to tax food purchases, allowing those individuals who use food stamps (a large majority of the poor) to continue utilizing their existing exemption.

Implementing the recommendations put forth in this proposal could raise an additional 10-12% in revenues for the state of Illinois through an economically feasible alternative tax structure. The suggested structural changes would improve the fairness of the tax system, while maintaining Illinois' competitiveness.

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Endnotes

1. This section draws heavily from Merriman, Giertz, and McGuire (1997).

2. General funds finance most of the basic services provided by the state, including state-level support for K- 12 and higher education. The major functional area not financed by general funds is roads and highways.

3. Illinois' percentages are low in comparison to the U.S. averages because of the state's relatively heavy reliance on local property taxes.

4. For those in the $0 to $5,000 income class, the inclusion of food in the base would likely result in an increase of about one percentage point instead of the more than two percentage-point increase indicated in Table 3 because of the tax-exempt status of food stamp purchases (Giertz and McGuire 1997).

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