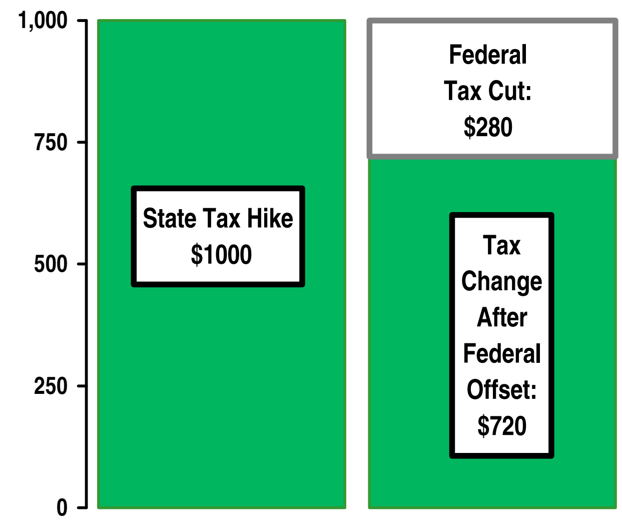
CHAPTER SEVEN

TAX REFORM OPTIONS FOR ILLINOIS

Legislators may choose to reform tax structures for a number of reasons. They may find that the tax system raises too little money—or too much. They may wish to change the balance between different taxes. Or they may find that the tax system discriminates between similarly situated taxpayers. This chapter includes descriptions of thirty distinct options for addressing these problems. Each option is accompanied by a **distributional analysis** which measures the net effect on Illinoisans' tax burden and a **revenue estimate** for calendar year 2000. The proposals are grouped into three general categories: revenue-raising options, revenue-reducing options, and revenue-neutral options.

The bar chart to the right shows the impact of these options on each Illinois income group, expressed as a percentage of personal income. The solid portion of each bar represents the state tax change (after taking federal tax changes into account) for each income group. Where there are federal tax ramifications stemming from a proposal (because of federal itemized deductions for Illinois income and property taxes paid), the charts also include grey lines that show the proposal's effects *before* consideration of the federal offset. We have presented our data in this way because for those who itemize deductions on their federal tax return, changes in state income taxes or property taxes can produce substantial offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Illinoisans, including federal and state taxes. The following example shows how to interpret these charts.

Suppose an itemizing Illinois taxpayer in the 28 percent federal tax bracket is subject to a $1,000 increase in Illinois income taxes. The value of her federal itemized deductions will increase by $1,000. This means that $1,000 *less* of this taxpayer's income will be subject to federal tax after the Illinois tax cut. Since this untaxed income is taxed at 28 percent, federal tax liability decreases by $280. So the net *overall* tax hike for this itemizing Illinois taxpayer from a $1,000 hike in state tax liability is actually $720, not $1000. Our distributional analysis of this proposal (below) shows that taxpayers do not pay the full $1,000 tax hike, since $280 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax



impact of this proposal (on the left) would substantially overestimate the additional tax burden on Illinoisans from this proposal.

If, on the other hand, the same taxpayer experienced a $1,000 sales tax hike, federal tax payments would not change, because sales taxes cannot be deducted by federal itemizers. This means that the entire $1,000 tax hike would paid by the taxpayer. The choice between sales and income tax hikes does not affect state revenues—the state receives an extra $1,000 with either approach—but the taxpayer fares much worse under the income tax proposal than under the sales tax proposal.

This relationship holds true for income and property tax *reductions*, as well: a cut in these taxes that is targeted to federal itemizers will be partially offset by federal income tax increases. If these tax cuts are clearly targeted toward wealthy taxpayers who pay at the top federal rates (as is the case with the capital gains tax cut in Option 25), more than a third of the state tax cuts may go directly to the coffers of the federal government rather than going to the pockets of Illinoisans. It hardly seems likely that Illinois lawmakers would intentionally design a tax cut that effectively throws away a third of its cost—yet this is the effect of any income tax break that targets its benefits to the best-off Illinoisans.

TABLE OF CONTENTS FOR OPTIONS

Revenue-Raising Options

In this section we offer several revenue-raising tax reform options. The options presented here include *base-broadening* measures designed to increase the yield of Illinois taxes without raising rates (including Option 5, which would eliminate tax preferences for retirement benefits, and Option 10, which would extend the 6.25 percent statewide sales tax to sales of groceries); *rate hike* measures which would simply increase tax rates without affecting the tax base; and *targeted* measures which would narrow the scope of existing tax preferences.

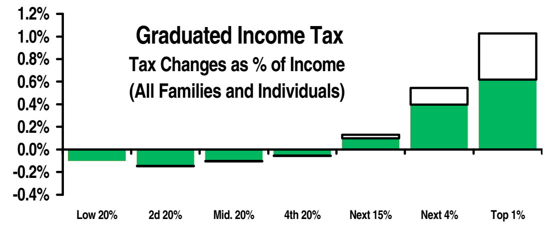
1. Graduated Income Tax

Principal Features

- Replaces the flat-rate income tax with a 3-tier graduated rate ranging from 2.7 percent to 4.25 percent.
- Cuts taxes for 60 percent of Illinoisans.
- Increases Illinois taxes by $1 billion.
- Reduces federal taxes by $400 million.
- Requires a constitutional amendment.

Discussion

Illinois is one of only six states to impose a flat-rate income tax—and has the second-lowest tax rate of any flat tax state. This option creates a new three-rate income tax, with rates of 2.75, 3.5, and 4.25 percent. Because the first $50,000 of taxable income would be taxed at a lower rate for joint filers (the first $25,000 for single filers), a majority of Illinoisans would see a net tax cut under this proposal. Twenty-one percent of Illinoisans would experience a state tax hike, but about 40 percent of the tax increase would be offset by federal tax cuts. This option takes advantage of the interaction between state and federal income taxes by *lowering* taxes on those Illinoisans least likely to itemize their federal taxes and *increasing* taxes on those Illinoisans most likely to itemize.



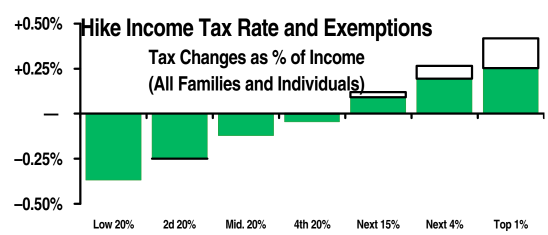
2. Increase Income Tax Rate, Increase Personal Exemption to $5,000

Principal Features

- Increases the flat income tax rate to 3.5 percent.
- Increases the personal and dependent exemption to $5,000.
- Cuts taxes for 45 percent of Illinoisans.
- Increases Illinois income taxes by $370 million.
- Reduces federal taxes by $180 million.

Discussion

This option increases the progressivity of the Illinois income tax by increasing the flat tax rate to 3.5 percent and increasing the personal and dependent exemptions to $5,000. This change results in a net tax cut, on average, for every income group except the wealthiest twenty percent, bringing in $370 million in new Illinois revenue and reducing federal tax payments by Illinoisans by $180 million. The federal government picks up more than 40 percent of the tab for this tax increase.



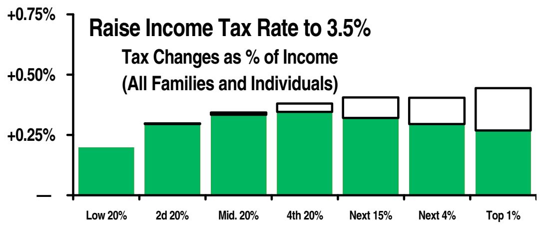
3. Raise Personal Income Tax Rate to 3.5%

Principal Features

- Increases Illinois taxes by $1.375 billion.
- Reduces federal taxes by $285 million.
- Moderately progressive tax increase.

Discussion

This change would increase the progressivity of the overall Illinois tax system, but would result in a tax hike for all income-tax payers. Twenty percent of the state tax hike would be paid for directly by the federal government in the form of federal income tax cuts for Illinois itemizers.



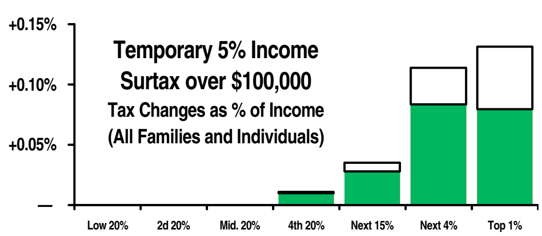
4. Impose a Temporary 5% Surtax on Taxable Income Over $100,000

Principal Features

- Increases Illinois taxes by $190 million.
- Reduces federal taxes by $35 million.

Discussion

This proposal imposes a one-time flat 5 percent surtax on Illinois taxpayers with incomes over $60,000 (for singles) and $120,000 (for joint filers). Just under 10 percent of taxpayers would have been affected by this option in tax year 2000. A substantial percentage of the state tax hike from this option would be offset by lower federal income tax payments for Illinois itemizers.



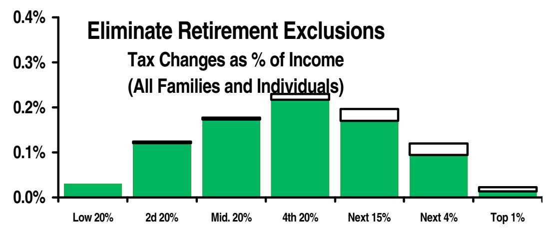
5. Eliminate Pension and Social Security Exclusions

Principal Features

- Increases Illinois taxes by $500 million.
- Reduces federal taxes by $50 million.

Discussion

This proposal increases the yield of the personal income taxes by removing two poorly targeted—and expensive—exemptions for retirement income. Because the wealthier taxpayers predominantly affected by this option are more likely to itemize their federal taxes, federal taxes paid by Illinoisans would decline by $50 million under this option.



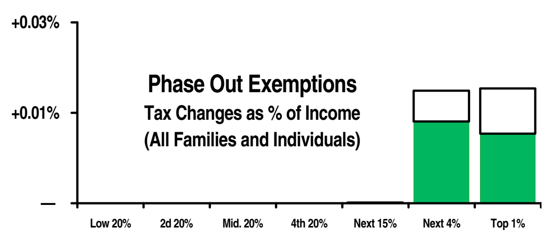
6. Phase Out Personal Exemptions

Principal Features

- Disallows personal exemptions for taxpayers with incomes over $128,950.
- Increases Illinois taxes by $20 million.
- Decreases federal taxes by $7 million.
- Progressive tax increase.

Discussion

This option raises $20 million. The option phases out the value of the $2,000 personal exemption over an income range starting at $128,950 for singles and $193,400 for married couples. Less than 3 percent of Illinoisans would be affected by this change.



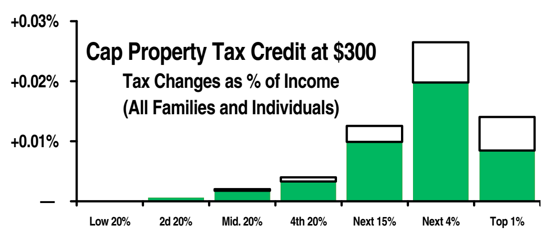
7. Cap the 5% Property Tax Credit at $300

Principal Features

- Limits the value of the income-tax-based property tax credit to $300.
- Improves the targeting of the Illinois credit.
- Increases Illinois income taxes by $38 million.
- Reduces federal taxes by $10 million.

Discussion

This option increases the progressivity of the Illinois tax system by placing a ceiling on the dollar amount of the 5 percent property tax credit claimed on Illinois income tax forms. This limitation primarily affects wealthier Illinoisans: 90 percent of the Illinois tax hike under this proposal would be paid by the wealthiest 20 percent of state residents, and the poorest 60 percent of Illinoisans would pay less than 3 percent of the state tax hike. Many lower-income taxpayers are unaffected because they cannot claim the full $500 credit under current law. Because state income taxes are deductible on federal income tax forms for Illinois itemizers, this option reduces federal income taxes by $10 million.



8. Increase Property Tax Homestead Exemption, Increase Personal Exemption, Increase Income Tax Rate

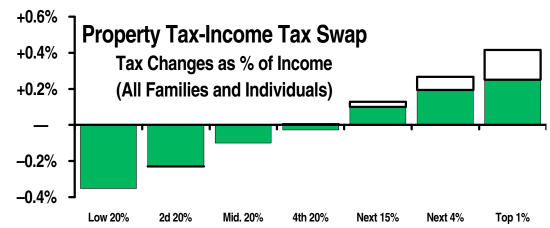
Principal Features

- Increase homestead exemption from $3,500 ($4,500 in Cook County) to $7,000 statewide.
- Increase personal and dependent exemption to $5,000, increase personal income tax rate to 3.5 percent.
- Increases Illinois taxes by $400 million.

Discussion

This option takes a step toward the sort of tax swap discussed through the 1990s in Illinois by increasing the property tax homestead exemption to a flat $7,000. The income tax personal and dependent exemption is increased to $5,000, and the income tax rate is increased to 3.5 percent.

This option increases state revenues by $400 million, but more than 40 percent of the tax hike is offset by a federal tax cut for itemizers. Federal taxes fall by $190 million under this proposal. Only the wealthiest twenty percent of taxpayers, on average, experience a state tax hike under this proposal.



9. Cigarette Tax Increase

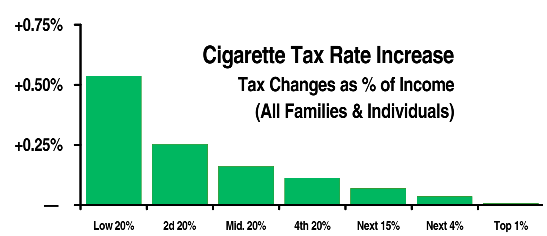
Principal Features

- Raise cigarette tax by $0.42 cents per pack so that the rate reaches $1.00 per pack.
- Regressive tax increase.
- Increases Illinois taxes by $325 million.
- Federal taxes are not affected by this change.

Discussion

The Illinois cigarette tax rate is already comparatively high—and has doubled since 1993. By increasing the tax rate to $1.00 per pack from the current $0.58, this option would obviously exacerbate regressivity. Some argue, however that increases in cigarette taxes may discourage smoking. Raising the tax to $1.00 could have this effect, although the evidence is mixed at best.

Because excise taxes are not deductible on federal income tax forms, none of the added excise tax burden would be offset by federal tax cuts.



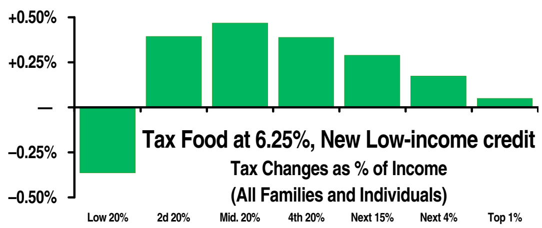
10. Extend State Sales Tax to Groceries, Introduce Low-Income Food Tax Credit

Principal Features

- Applies the full 6.25 percent state sales tax to food.
- Provides targeted food tax relief to low-income Illinoisans.
- Increases Illinois taxes by $800 million.

Discussion

This option broadens the Illinois state sales tax base by applying the same 6.25 percent rate to sales of groceries as is currently applied to most other base items. The sales tax hike on lower-income taxpayers is offset by a grocery tax credit.



11. Increase Cigarette Tax and Earned Income Tax Credit

Principal Features

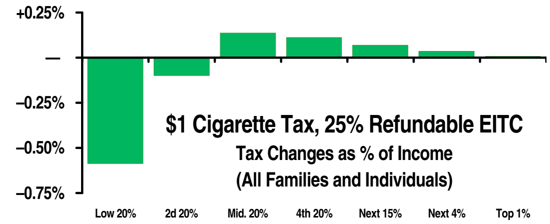
- Increases regressive cigarette taxes to $1.00 per pack.
- Offsets impact of cigarette tax hike with an expanded Earned Income Tax Credit.
- Increases Illinois taxes by $115 million.

Discussion

This option includes the 42-cent cigarette tax hike modeled in Option 9 and the 30 percent refundable Earned Income Tax Credit modeled in Option 21.

Because excise tax increases—especially cigarette taxes—hit low-income taxpayers most heavily as a share of personal income, low-income tax credits may be used to offset some of the additional tax burden. The option shown actually results in a net tax cut, on average, for the poorest 40 percent of Illinoisans.

12. Expand Sales Tax Base to Include All Services

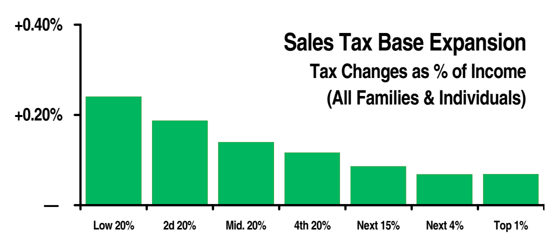


Principal Features

- Includes many personal services in the state sales tax base.
- Impact of tax increase is greatest for low- and middle-income taxpayers.
- Increases Illinois taxes by $330 million.

Discussion

This option augments the state sales tax base by taxing personal services such as haircuts, repair services, and club membership dues and fees. The option raises $330 million. Although adding services to the sales tax base makes the sales tax regressive, the impact of this tax option is nonetheless clearly regressive compared to income- or property-tax based options; the poorest 20 percent of Illinois taxpayers would pay an extra 0.6 percent of their income in taxes under this proposal, while the wealthiest one percent of taxpayers would pay less than 0.1 percent more as a share of income. If such a sales tax expansion includes business services, it could encourage businesses to produce these services themselves, leading to artificially high levels of vertical integration.



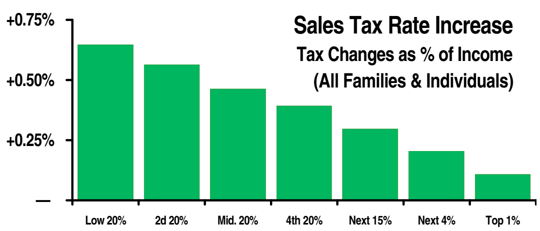
13. Raise General Sales Tax Rate

Principal Features

- Raises state sales tax rate from 6.25 percent to 7.25 percent.
- Regressive tax increase.
- Increases Illinois taxes by $1.3 billion.

Discussion

The general sales tax is the least progressive major tax levied by the state—and Illinois already has one of the highest state sales tax rates in the nation. Because sales taxes are not deductible on federal income tax forms, none of the added sales tax burden would be offset by federal tax cuts.



Revenue-Neutral Options

Legislators nationwide are showing an increasing interest in revenue-neutral tax reforms. These reforms are often designed to shift the state and local tax burden from one tax base to another—or to broaden the base of a particular tax while simultaneously dropping the tax rate. In this section we offer several tax reforms that broaden or shift the tax base, leaving Illinois tax collections approximately unchanged in 2000—but which (in some cases) affect federal taxes paid by Illinois residents, while shifting the distribution of tax liability between income groups.

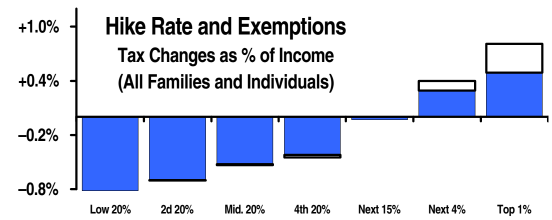
14. Increase Income Tax Rate and Exemptions

Principal Features

- Increases personal exemption from $2,000 to $12,000 and dependent exemptions from $2,000 to $4,800.
- Increases income tax rate from 3 to 4 percent.
- Progressive impact on tax burden.
- Reduces federal taxes by $275 million.

Discussion

This option makes the nominally flat Illinois income tax more like a typical progressive tax in its incidence. The option increases the state income tax rate from 3 percent to 4 percent. While such a change would, in isolation, constitute a mildly progressive across-the-board tax increase, the rate hike on low- and middle-income taxpayers is completely offset by an increase in the personal exemption from $2,000 to $12,000, along with a simultaneous increase in the dependent exemption from $2,000 to $4,800.



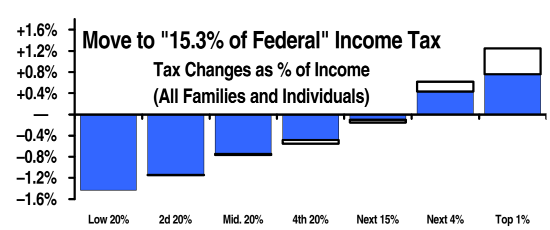
15. Move to "15.3 Percent of Federal" Personal Income Tax

Principal Features

- Simplifies Illinois income tax calculation.
- Defines Illinois income tax liability as 15.3 percent of federal tax liability.
- Reduces federal taxes by $360 million.

Discussion

This reform would help simplify the Illinois income tax—under a percent of federal system, taxpayers would simply multiply their federal tax liability by 15.3 percent to calculate their state income tax liability. For most taxpayers, this would reduce the income tax to three steps and just two lines. This



option has a progressive impact, since the tax is calculated by applying a percentage of a progressive tax. While state taxes would be unchanged by this proposal, federal taxes paid by Illinois residents would fall by $360 million.

16. Simplify Tax Filing for Elderly Taxpayers

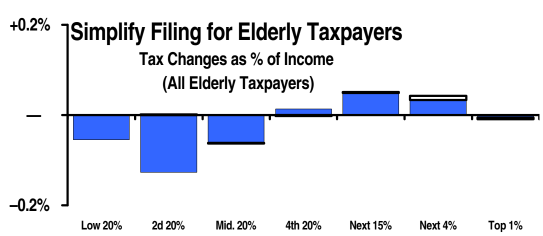
Principal Features

- Eliminates Illinois exemptions for pension and Social Security benefits.
- Provides extra over-55 all-source exemption to compensate.
- Reduces federal taxes by $4 million.

Discussion

This option provides progressive tax relief, while simplifying the tax-filing process for elderly Illinois residents. The option eliminates special Illinois exemptions for pension and Social Security income, treating both income sources just as they are treated on the federal tax form. The extra Illinois revenue from eliminating these exemptions is used to create a special over-55 per-filer exemption of $12,000.

For elderly taxpayers, this option simplifies the tax filing process by eliminating differences between federal and Illinois AGI. It is fiscally responsible, since it costs the state nothing to enact. This option increases the progressivity of the tax system by cutting taxes on the poorest 60 percent of taxpayers over 55. And it increases the horizontal equity of the tax system by treating all elderly taxpayers at a given income level the same, no matter what their income source. The tax hike on the best-off five percent is partially offset by a decrease of $4 million in total federal tax liability.



17. Increase Homestead Exemption, Increase Personal Income Tax

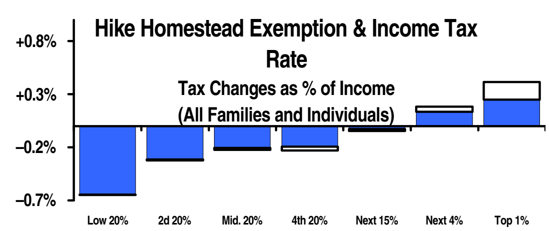
Principal Features

- Increases homestead exemption from $3,500 to $10,000.
- Increases income tax rate from 3 percent to 3.5 percent.
- Reduces federal taxes by $100 million.

Discussion

Like Option 8, this option represents a shift away from regressive property taxes, and toward progressive income taxes, as a revenue source. Unlike Option 8, the approach modeled here leaves net Illinois taxes unchanged, and simply shifts tax dollars from the property tax to the income tax. A reduction in the moderately regressive property tax is offset by an increase in the income tax rate. Every income group except the wealthiest twenty percent sees, on average, a net tax cut under this option.

The property tax reduction element of this proposal extends the homestead exemption amount to $10,000. As explained in the text accompanying Option 28, this exemption increase will have a progressive impact on the tax burden. While this approach leaves total Illinois state tax revenues unchanged, it results in a net federal tax *cut* of $100 million for Illinoisans.



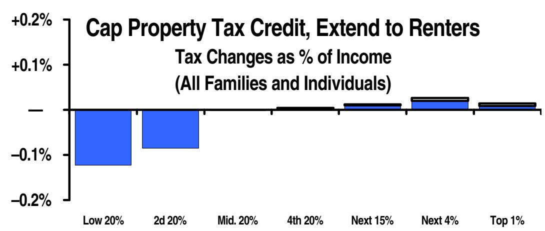
18. Cap Property Tax Credit, Make Available to Renters

Principal Features

- Following the example of the one-time property tax rebate offered in 1999, this option would cap the existing property tax credit at $300 per return.
- The revenue windfall from capping the property tax credit is used to provide a property tax relief credit for renters.
- Reduces federal taxes by $10 million.

Discussion

This option addresses one of the principal inequities in the Illinois property tax—the lack of major property tax relief mechanisms directed toward non-elderly renters. Because it shifts the property tax burden from poorer taxpayers—who tend not to itemize their federal tax returns—to wealthier taxpayers who do generally itemize, this shift has the effect of reducing federal taxes paid by Illinois residents. Thus, while the option leaves Illinois tax collections unchanged, it reduces the *overall* taxes paid by Illinois taxpayers.



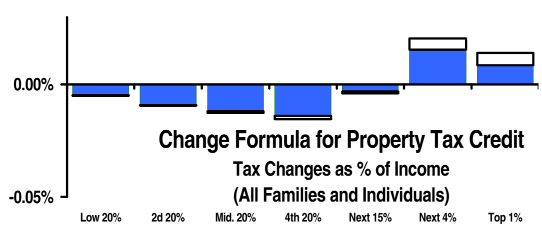
19. Change Formula for Property Tax Credit

Principal Features

- Caps property tax credit at $300 per return.
- Increases percentage of property tax rebated to 5.8 percent.

Discussion

This option makes the property tax credit better targeted to achieve low- and middle-income property tax relief. The 5 percent property tax credit, which currently has no dollar limit, is capped at $300 per return, and the 5 percent refund rate is increased to 5.8 percent. This approach provides substantial tax relief for lower-income Illinoisans while leaving the total Illinois tax burden



unchanged—and cuts the federal taxes paid by Illinoisans by over $4 million.

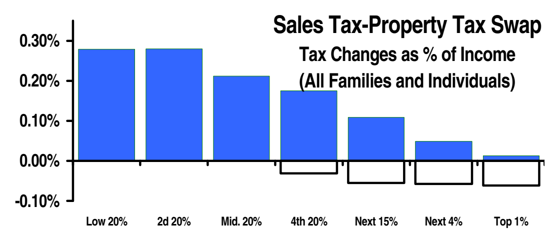
20. Increase sales tax, cut property tax

Principal Features

- Increases statewide sales tax rate from 6.25 percent to 7.25 percent.
- Decreases Illinois's reliance on property tax revenues.
- Increases federal taxes by $130 million.

Discussion

This option raises taxes on Illinoisans at all levels. While Illinois property taxes are regressive, the state's sales tax is marginally more regressive. This means that a revenue-neutral property-tax-for-sales-tax swap will increase the regressivity of the tax system. Federal taxes would increase by $130 million as a result of this change, since property taxes are deductible for federal itemizers but sales taxes are not. This is important for wealthier taxpayers, who would see a net state tax *cut* under this option but would have that cut completely offset by increasing federal tax liability. Finally, since sales taxes are more likely to fall on in-state residents than are property taxes, this option shifts a greater share of the Illinois tax burden onto Illinoisans.



Revenue-Reducing Options

This section outlines several revenue-reducing tax reform options. All of these proposals reduce the aggregate Illinois tax burden—and reduce state and local funds available for providing public services. Some of these options combine revenue reductions with base broadening. Others simply narrow the base or reduce tax rates.

21. Increase The Earned Income Tax Credit

Principal Features

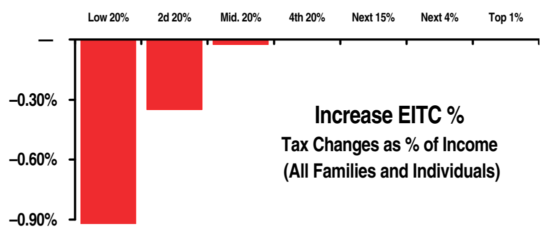
- Increases the Illinois Earned Income Tax Credit (EITC) from 5 percent to 30 percent of the federal EITC.

- The currently nonrefundable EITC is made refundable.
- Reduces Illinois taxes by $210 million.
- Targeted to lower-income working families.

Discussion

Illinois's 5 percent EITC, created in 1999, is the smallest such credit currently available. The Illinois EITC is also non-refundable, a trait shared by only six other state EITCs. This option corrects both of these shortcomings by increasing the value of the credit to 30 percent of the federal credit and by making the credit refundable.

Because this credit only affects lower-income families who rarely itemize deductions on their federal return, the impact of this option on federal taxes paid by Illinoisans is negligible.



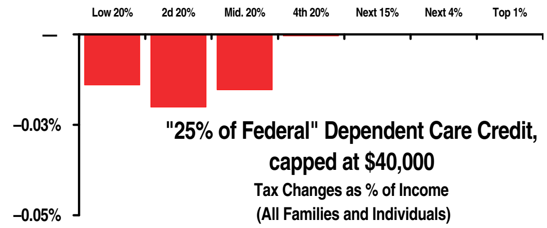
22. Dependent Care Credit Based on the Federal Credit

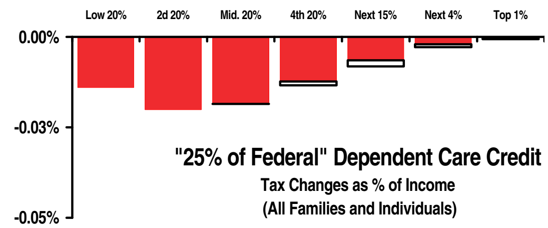
Principal Features

- Creates a nonrefundable dependent care credit equal to 25 percent of the federal credit, capped at $40,000 of income.
- Reduces Illinois taxes by $13 million, or $32 million if the $40,000 limit is eliminated.
- Larger tax cuts for lower- and middle-income taxpayers.
- No change in federal taxes paid. If the $40,000 limit is eliminated, federal taxes increase by $3 million.

Discussion

The federal government allows a non-refundable income tax credit of up to 30 percent of allowable child care expenses. The federal credit is reduced to 20 percent of expenses for taxpayers earning over $28,000, but is available to taxpayers at all income levels. This makes the dependent care credit more expensive. Removing the income eligibility cutoff of $40,000 per family would increase the estimated cost of this credit from $13 million to $32 million in tax year 2000.





23. Increase the Personal Exemption to Conform to the Federal Exemption

Principal Features

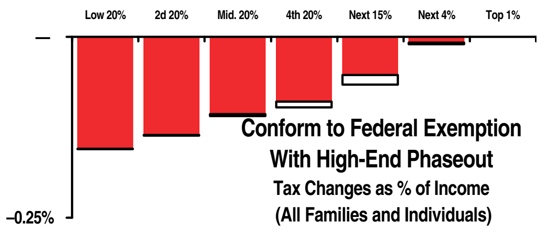
- Increases the personal exemption from $2,000 per person to $2,800 per person.
- Reduces Illinois taxes by $235 million ($210 million if phased out at high incomes).
- Provides greater tax cuts for lower-income taxpayers.
- Increases federal taxes by $23 million ($12 million if exemption is phased out at high incomes).

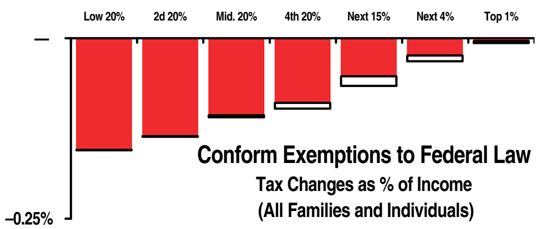
Discussion

Illinois allows a $2,000 personal exemption for each member of a family, and an additional $1,000 exemption for taxpayers over age 65. This option increases the tax year 2000 personal exemption from $2,000 to $2,800—the amount allowed on federal income tax forms in 2000. This option has a progressive impact, although the 18 percent of low-income families that currently do not owe income tax would not benefit from the exemption hike.

Because a simple exemption hike allows a substantial tax cut for wealthier taxpayers, a portion of the upper-income tax break goes to the federal government in the form of higher federal income tax payments. This result could be avoided by creating a personal exemption phase-out similar to the federal phase-out.

If this change were enacted by explicitly tying the state personal exemption to the federal personal exemption for each tax year, the problem of inflationary loss in the personal exemption would be eliminated.





24. Personal Income Tax Rate Cut

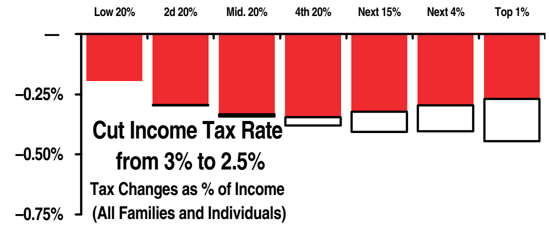
Principal Features

- Cuts the state income tax rate from 3 percent to 2.5 percent.
- Reduces Illinois taxes by $1.4 billion.
- Increases federal taxes by $280 million.

Discussion

This approach to tax reform is sometimes characterized as an across the board tax cut. After all, proponents argue, if the state's income tax rate is cut by 15 percent, then everyone should get the same tax break. The flaw in this argument is that the state personal income tax is only a portion of total state and local taxes—and the most progressive portion to boot. This means that a cut in the personal income tax while leaving other, more regressive, taxes untouched makes the tax system as a whole more regressive. If a 15 percent cut were proposed in *all* state taxes, such a cut would indeed be across the board and even-handed. It would also, of course, be tremendously expensive and would do nothing to reduce the regressivity of the current system.

While this option reduces state revenues by $1.4 billion, only $1.1 billion of this cut finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.



25. Exempt 100 percent of capital gains income from taxation

Principal Features

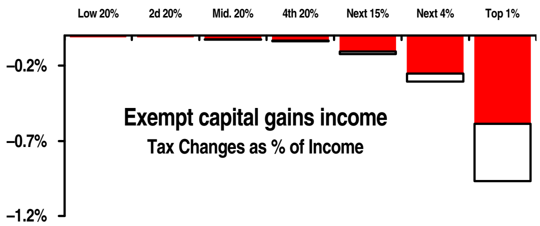
- Reduces Illinois taxes by $1 billion.
- Tax cuts primarily to the wealthy.
- Increases federal taxes by $330 million.

Discussion

Capital gains tax cuts are often discussed as a means of encouraging economic growth through increased investment. Yet there is no clear evidence that capital gains tax cuts encourage growth even at the federal level. And capital gains exclusions are probably less effective as an approach to economic development when they are administered at the state level, since the additional investment (if any) encouraged by the capital gains exemption could take place anywhere in the United States or the world.

An equally important flaw of this approach to tax relief is that a substantial portion of this tax cut would flow not to the pockets of Illinoisans but to the federal government. The federal personal income taxes paid by Illinoisans would go up by $330 million under this option because of the decrease in deductions for state personal income tax paid. While this option reduces state revenues by just over $1 billion, only $670 million of this cut—about two-thirds of the revenue loss to the state—finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.

In addition, the benefits of a capital gains tax cut are skewed toward the wealthiest Illinois taxpayers. The wealthiest one percent of Illinois taxpayers alone would receive 70 percent of the state tax cut from this option.



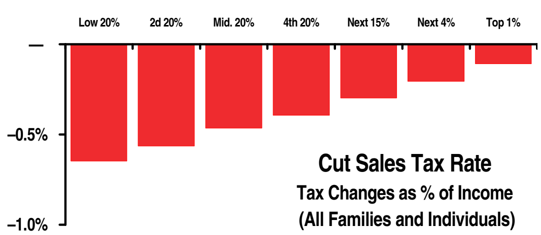
26. Sales Tax Rate Cut

Principal Features

- Cuts statewide sales tax rate from 6.25 percent to 5.25 percent.
- Reduces Illinois taxes by $1.3 billion.
- Progressive (but expensive) tax cut.

Discussion

The Illinois state sales tax rate is one of the highest in the nation at 6.25 percent. This option provides progressive tax relief, reducing the state rate by 1 percent. (The tax rate on lower-rate items such as food and utilities is left unchanged.) Lower- and middle-income Illinoisans see a significantly greater tax cut as a share of income than do the wealthy. However, this approach would reduce state sales tax revenues by more than 15 percent. Because sales taxes are not deductible by federal itemizers, federal taxes paid by Illinois residents would not increase.



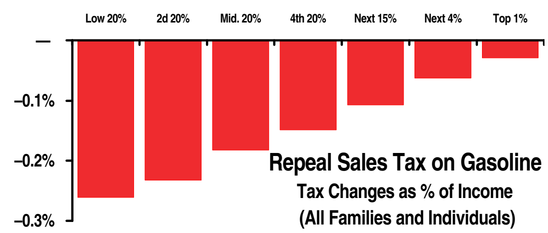
27. Permanent Elimination of Sales Tax on Gasoline

Principal Features

- Eliminates gasoline from the state sales tax base.
- Reduces Illinois taxes by $300 million.
- Progressive tax cut.
- Makes sales tax base more narrow.

Discussion

Illinois is one of only nine states to tax gasoline with a separate excise tax while including sales of gasoline in the general sales tax base. This option would repeat, on a permanent basis, the temporary tax relief offered by the Illinois legislature in 2000. Because excise taxes are not deductible by federal itemizers, federal taxes paid by Illinois residents would be unchanged. When Illinois lawmakers enacted this tax break on a temporary basis in 2000, there was some public concern over the question of whether the tax cuts were actually being passed through to taxpayers: it is assumed here that taxpayers realize the full savings from the cut.



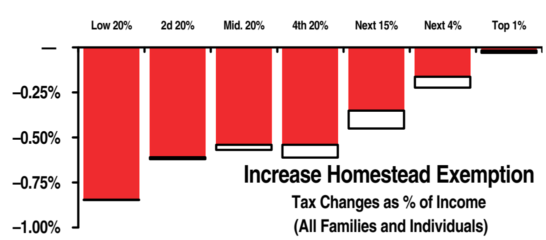
28. Increase Property Tax Homestead Exemption

Principal Features

- Increases homestead exemption maximum from $3,500 to $10,000.
- Reduces Illinois taxes by $1.375 billion.
- Progressive tax cut.
- Increases federal taxes by $180 million.

Discussion

Under current law, the Illinois homestead exemption provides property tax relief equal to the increase in the assessed value of a property over its 1977 assessed value, with a maximum of $3,500. This option increases the maximum available homestead exemption from $3,500 to $10,000, and makes the exemption independent of the change in value since 1977. This exemption increase would



have a progressive effect on the Illinois tax burden, because exempting the first $10,000 of home value would mean a 25 percent reduction in tax on a $40,000 home, and a 10 percent reduction on a $100,000 home. But because the homestead exemption is available to taxpayers at all income levels, close to $200 million of the state tax cut would be offset by federal income tax increases.

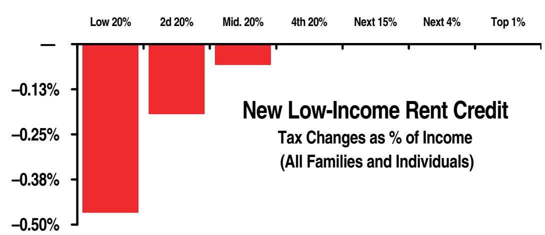
29. New Low-Income Renter Credit

Principal Features

- Creates low-income property tax credit for renters.
- Credit capped at $100 ($200 for couples).
- Reduces Illinois taxes by $120 million.

Discussion

As discussed in Chapter Four, Illinois allows a property tax credit to those elderly and disabled homeowners and renters with incomes under $28,000, but does not provide a similar credit to non-elderly renters. This option creates a $100 non-refundable income tax credit against rental property taxes for taxpayers earning less than $20,000 ($40,000 for married couples). Because renters tend to be less wealthy, this is a progressive change.



30. Increase Property Tax Credit to 10 Percent

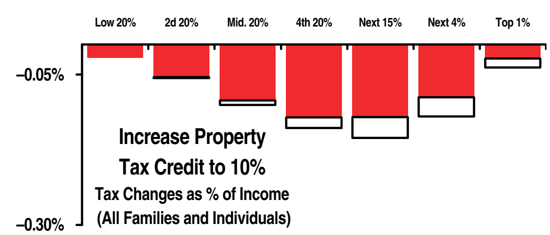
Principal Features

- Doubles the income tax credit against property taxes from 5 percent of property taxes to 10 percent.
- Affects relatively few low-income taxpayers.
- Reduces Illinois taxes by $370 million.
- Increases federal taxes by $70 million.

Discussion

Illinois currently allows all income-tax payers a nonrefundable income tax credit of five percent of homeowner property taxes paid. The progressivity of the credit is limited by its inapplicability to taxpayers who rent their homes or apartments, and by its nonrefundability. This would also be true of the proposal modeled here—it would not expand the number of taxpayers receiving the credit, but would simply increase the percentage of property taxes offset for those currently receiving the credit.

While this option reduces state revenues by $370 million, only $300 million of this cut finds its way back into the pockets of Illinois taxpayers. The rest goes directly to the federal government in the form of increased federal tax liability.



CHAPTER EIGHT

CONCLUSION

This report has shown that chronic imbalances exist within the Illinois tax structure—and that sensible remedies exist for the structural flaws that limit the yield and progressivity of Illinois taxes.

In recent decades, lawmakers of all stripes have expressed interest in systematic tax reform. Yet, as this study has shown, the tax changes enacted in recent years have only perpetuated the balancing act that characterizes Illinois tax policy.

- Illinois has historically relied primarily on property taxes to fund elementary and secondary schools and other government functions. Yet while states across the nation have moved to reduce their reliance on these regressive property taxes through expansion of the income and sales tax base, Illinois has bucked this trend by further *increasing* its reliance on local property taxes as a revenue source. Meanwhile, the aggregate Illinois tax burden from the other traditional state and local revenue sources—personal income taxes and consumption taxes—remains below average.
- While Illinois lawmakers have enacted a series of mechanisms for property tax relief over the years, these tax credits and deductions are either expensive and poorly targeted (as is the case with the five percent property tax credit) or have lost much of their value for low-income taxpayers (as is true of the elderly circuit breaker and the homestead exemption).
- The Illinois income tax has historically been a low-yield tax because of its low, flat rate. Yet the provision of costly tax breaks for pensions and Social Security income, and exclusions for property taxes paid and education expenses, has further depleted the yield of the tax. This narrow-base strategy has made it considerably more difficult for lawmakers to provide meaningful low-income tax relief. Recently enacted increases in the state's personal exemption have been far from sufficient to offset the declining real value of the exemption. And while the state Earned Income Tax Credit offers important low-income tax relief, the non-refundability of the credit and its low 5 percent rate limits its usefulness to Illinois taxpayers.
- The Illinois sales tax base is among the narrowest in the nation, due to the almost complete exclusion of personal and professional services from the base, and due to costly partial exemptions for groceries and drugs. As a result, state and local governments must apply higher-than-average rates in order to obtain a sufficient stream of sales tax revenue.

These long-term imbalances in the Illinois revenue structure hurt low- and middle-income Illinoisans both directly, in the form of an oppressively high tax burden on the low-income taxpayers who are least able to afford it, and indirectly, by reducing the state's ability to fund important government services in the long run.

As the state continues to grapple with these issues, we hope that this report will help lawmakers and the public achieve a better understanding of the options available for achieving greater balance in the Illinois tax system.