

# THE ILLINOIS PERSONAL INCOME TAX

Illinois is a low-income tax state. Among the 41 states that currently collect a broad-based income tax, only four states tax a lower percentage of personal income than Illinois. Yet the Illinois tax burden on the very poorest Illinoisans is among the *highest* in the nation. Illinois' flat-rate structure and its poorly targeted exemptions and credits reduce the yield and progressivity of the tax, and fails to take advantage of the interaction between state and federal taxes. Perhaps most important, the low-yield, low-fairness structure of the tax stands as a roadblock to the state's ability to provide meaningful low-income tax relief while funding important government services.

## A Low Income-Tax State

Illinois' personal income tax burden is lower than that of most other states levying such a tax. In 1999, Illinois personal income taxes represented 2.0 percent of personal income, ranking the state 37<sup>th</sup> highest nationally. Among the 41 states levying broad-based income taxes in 1999, only four states imposed a lower personal income tax burden.<sup>1</sup>

While the Illinois income tax burden has grown somewhat over the past two decades, other states have, on average, increased their income tax reliance even faster.

Since 1979, Illinois' personal income tax burden has fallen from 29<sup>th</sup> highest in the nation to 37<sup>th</sup> highest. Similarly, while Illinois has increased the percentage of its total tax revenues that come from income taxes, other states have done so at a faster rate. As a result, the income tax burden, 17 percent below the national average in 1979, is now 21 percent below the national average.

## Burdens and Trends in Illinois Income Taxes

	As a % of Personal Income				As % of Total Taxes			
	1979	US Rank	1999	US Rank	1979	US Rank	1999	US Rank
Illinois	1.6%	29	2.0%	37	15.6%	29	19.1%	36
Indiana	1.4%	35	2.8%	18	15.9%	28	27.1%	17
Iowa	2.2%	17	2.4%	33	21.5%	14	22.9%	32
Kentucky	2.4%	11	3.6%	8	23.8%	10	33.0%	4
Michigan	2.5%	9	2.7%	22	22.4%	12	25.0%	23
Missouri	1.6%	27	2.7%	21	18.0%	23	27.5%	15
Wisconsin	3.4%	6	3.7%	6	28.5%	4	29.6%	11
<b>ALL STATES</b>	<b>1.9%</b>		<b>2.5%</b>		<b>17.9%</b>		<b>23.2%</b>	
<b>IL/ US avg</b>	<b>83%</b>		<b>79%</b>		<b>87%</b>		<b>82%</b>	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

## A Narrow Tax Base

Like most states, Illinois ties its income tax base directly to "federal adjusted gross income (AGI)" as determined on federal income tax forms. By adopting federal AGI as its starting point for state income tax purposes, the state of Illinois automatically excludes some forms of income from taxation. For example, federal AGI does not include most Social Security benefits, welfare benefits, gifts and bequests, medical savings accounts, alimony paid, student loan interest, and education IRAs. In addition, Illinois taxpayers must make several Illinois-specific adjustments to federal income to arrive at Illinois adjusted gross income. Illinois AGI differs from federal AGI in the following important ways:

- All federally taxable Social Security benefits are exempt from taxation in Illinois.
- All public and private pension benefits—including those benefits which are taxable on the federal level—are exempt from Illinois income taxation.
- Unemployment compensation, taxable on the federal level, is exempt in Illinois.

Several other Illinois-specific tax preferences further reduce the amount of Illinois income that is available for taxation.

<sup>1</sup>These states were Arizona, Louisiana, North Dakota, and Mississippi.

- Taxpayers are allowed personal exemptions of \$2,000 for each exemption claimed on the federal income tax form.

### Taxation of Personal Income in Illinois

<b>Total Taxpayer Income</b>
<b>Minus</b>
<b>Federally Exempt Income</b> Social Security & welfare benefits, etc.
<b>Equals</b>
<b>Federal Gross Income</b>
<b>Minus</b>
<b>Federal Adjustments</b> MSA's, Alimony Paid, Moving Expenses, etc
<b>Equals</b>
<b>Federal Adjusted Gross Income</b>
<b>Minus</b>
<b>Illinois Subtractions</b> Fed. Taxable Soc. Sec. Benefits, Fed. Interest
<b>Plus</b>
<b>Illinois Additions</b> Fed. Tax-Exempt Interest/Dividend Income
<b>Equals</b>
<b>Illinois Base Income</b>
<b>Minus</b>
<b>Personal Exemptions</b> \$2,000 per fed. exemption, \$1,000 for elderly
<b>Equals</b>
<b>Illinois Taxable Income</b>
<b>Multiplied by</b>
<b>3 percent tax rate</b>
<b>Equals</b>
<b>Tax Before Credits</b>
<b>Minus</b>
<b>Tax Credits</b> EITC, Property Tax Credit, Tuition Credit
<b>Equals</b>
<b>Net Tax Liability</b>

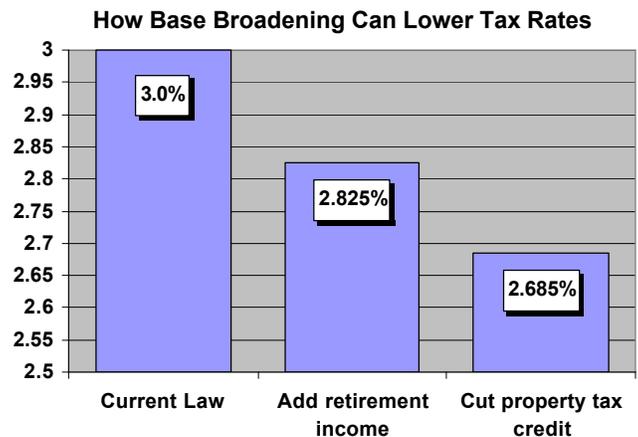
- A series of tax credits are available for eligible taxpayers, including the Earned Income Tax Credit, the property tax credit, and the education expense credit.

The net impact of these exclusions and credits is to narrow the Illinois income tax base considerably—and to reduce the yield of the income tax for each percent of income that is taxed. The following chart shows graphically the importance of these exclusions: in 2000, a 3 percent rate was sufficient to raise \$7.9 billion in revenues. In the absence of pension and Social Security benefit tax breaks, the tax rate could be lowered for all taxpayers to 2.825 percent with the same state revenue yield. If, in addition, the state's property tax credit were repealed, the Illinois tax structure could raise the same amount with a rate of 2.685 percent in tax year 2000. In other words, each income tax exclusion granted by lawmakers increases the rate that must be applied to everyone else's taxable income. The narrower the base, the higher the tax rate must be in order to raise a given amount of income. And the broader the base, the lower the rate can be.

### A Regressive Income Tax

The Illinois income tax, taken by itself, is slightly progressive: low-income taxpayers pay, on average, 1.0 percent of their income in Illinois income taxes, less than the percentage paid by all higher-income groups. Taxpayers in the middle 20 percent of the income distribution

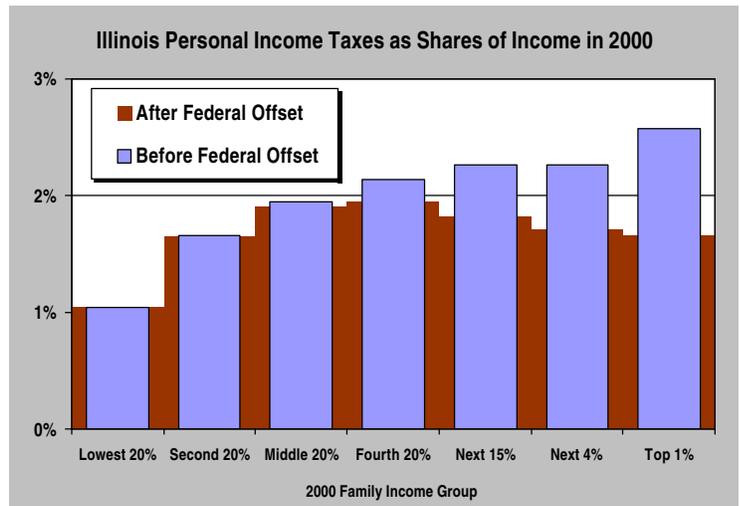
pay 2.0 percent of their income in state income taxes, and the top 1 percent of



Illinois taxpayers pay 2.5 percent of their income in state income taxes. Yet this modest degree of progressivity is dwarfed by the progressivity of most other state

income taxes.<sup>2</sup> And when the deductibility of state income taxes on federal income tax returns is taken into account, the Illinois income tax is actually *regressive* across the wealthiest 40 percent of the population. That is, the wealthiest 1 percent of taxpayers—with an average income of \$1.2 million—pay *less* in state income taxes, after the federal offset, than do taxpayers in the fourth quintile—a group with an average income of \$59,000.

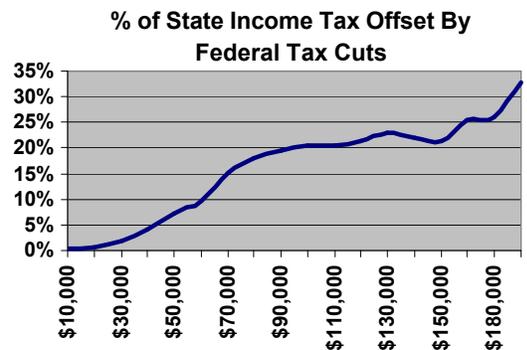
The lack of progressivity in Illinois' income tax has important implications for the state's overall tax structure. Since income taxes are typically the only major progressive tax levied by states, a flat-rate tax will do little or nothing to offset the inherent regressivity of the other major state and local taxes—consumption and property taxes. In fact, a central finding of ITEP's 1996 study, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, was that Illinois was one of the ten most regressive tax systems in the nation—largely because the income tax failed to offset the regressivity of the non-income tax burden.



## Factors Limiting the Progressivity of the Illinois Income Tax

The limited progressivity of Illinois' income tax is the product of several uncommon features of the state's tax structure. Most notably:

- Illinois is one of only six states to tax income at a **flat rate**.
- The state's **personal exemption** is relatively low, and is not currently indexed for inflation. And unlike most states, Illinois does not allow a **standard deduction**.
- The various **deductions and credits** offered by Illinois tend to favor higher-income taxpayers.



### Flat Rate

The principal reason for the lack of progressivity in Illinois' income tax is its low, flat rate structure. Illinois is one of only 6 states nationally to impose a broad-based income tax at a single flat rate. Of these states, only Pennsylvania has a lower tax rate.

The choice to levy a flat-rate tax has several consequences, none of them beneficial. First, by taxing all of the income of even the wealthiest taxpayer at the same rate as the poorest worker, it does not account for differences in "ability to pay" between poor and wealthy taxpayers. Second, because the fastest income growth tends to take place among high-income taxpayers, flat-rate income taxes tend to grow very slowly—and can even grow more slowly than the economy. Third, flat-rate taxes place a greater share of the burden on low-income taxpayers who cannot "export" their income tax to the federal government through itemized deduction. Progressive income taxes apply a greater share of the burden to wealthier taxpayers—which means that a larger

Flat-Rate Personal Income Taxes in 2001	
State	Rate
Massachusetts	5.6%
Colorado	4.75%
Michigan	4.2%
Indiana	3.4%
Illinois	3.0%
Pennsylvania	2.8%

<sup>2</sup>One of the findings of ITEP 1996 study, *Who Pays*, was that the Illinois income tax was less progressive than all but 3 of the 41 states levying broad-based income taxes. (The study measured the incidence of taxes on married non-elderly taxpayers in all 50 states.)

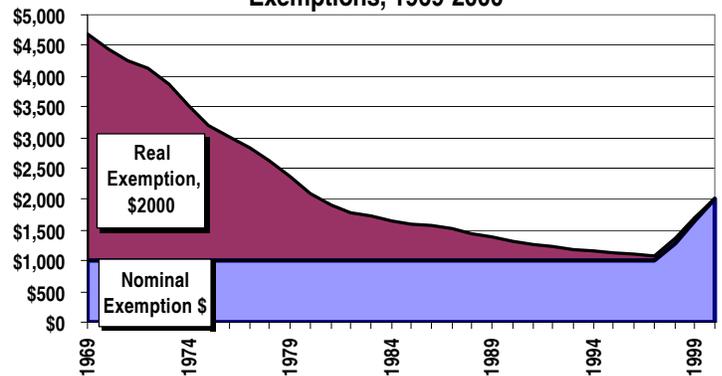
share of the tax is ultimately paid by the federal government. The chart at right shows the relationship between state income taxes and federal tax deductions as income increases. For low-income taxpayers, who rarely itemize, little or none of the state income tax burden is offset by federal tax deductions. At the very highest income levels, more than a third of state income tax liability is paid not by Illinois taxpayers but by the federal government. More so than most states, Illinois relies on income tax payments from low-income taxpayers. By doing so, Illinois policy makers miss an opportunity to export a substantial part of the state tax burden to the federal government.

### Small Personal Exemptions

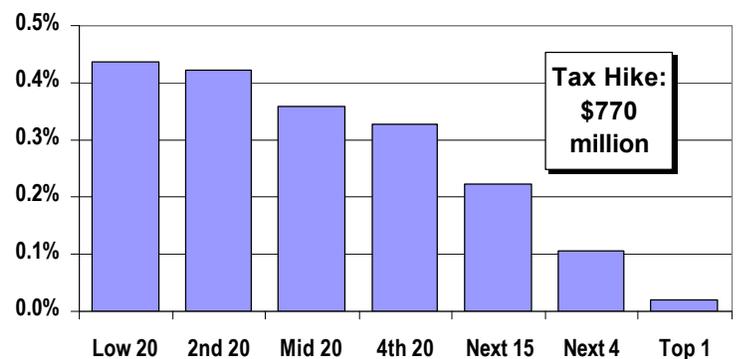
When the Illinois income tax was enacted in 1969, the personal exemption was set at \$1,000. The value of the exemption was left unchanged until 1998, when the legislature passed a bill doubling the exemption over three years. In tax year 2000, Illinois taxpayers could claim a personal exemption of \$2,000 for each exemption claimed on the federal income tax<sup>3</sup>, with an extra \$1,000 for each taxpayer who is over 65 or legally blind. While doubling the exemption has increased the fairness of the state income tax, the 1998 legislation has not been enough to offset a substantial decline in the real (inflation-adjusted) value of the exemption over time, as the chart at right shows. The original personal exemption of \$1,000 was actually worth almost \$4,700 in today's dollars. This means that the current \$2,000 personal exemption is worth less than half of the real value of the exemption enacted in 1969. In other words, inflation has inflicted a "hidden" tax hike that policymakers would never seriously consider—a 50 percent cut in the personal exemption available to Illinois taxpayers. As the following chart shows, this constitutes a substantial—and regressive—income tax hike. Illinois taxpayers paid \$770 million more in taxes in 2000 than they would have if personal exemptions had been indexed since 1969, and low-income Illinoisans bore the brunt of this tax hike.

Because the real value of the state's personal exemption has declined—and because the state does not allow a standard deduction—more of the income of poor families in Illinois is subject to income taxation than in most other states. A study by the Center on Budget and Policy Priorities found that the "tax threshold" in 2000 for a two-parent family of four—the amount of income that is shielded from taxation through standard deductions, personal exemptions and low-income credits—was lower in Illinois than in all but nine other states.<sup>4</sup> The study found that Illinois is one of

**The Declining Real Value of Illinois Personal Exemptions, 1969-2000**



**Real Exemption Cuts Due to Inflation, 1969-2000  
Tax Change as % of Income**



<sup>3</sup>Married joint filers are allowed a total of \$4,000 in personal exemptions.

<sup>4</sup>*State Income Tax Burdens on Low-Income Families in 2000: Assessing the Burden and Opportunities for Relief.* Bob Zahradnik, Nicholas Johnson, Michael Mazerov (2001). This ranking actually represented a substantial

only nineteen states that collect income taxes from two-parent families of four earning less than the poverty level in 2000.

### Targeted Income Tax Breaks

This is not to say that Illinois lawmakers have been stingy in enacting income tax loopholes. To the contrary, policymakers have enacted a host of poorly targeted and expensive tax credits and deductions which erode the income tax base, without providing meaningful low-income relief. Among the most expensive such provisions are a recently enacted tax credit for education expenses, exclusions for pension and Social Security benefits, and a credit against property taxes paid on owner-occupied homes.

#### Education Expense Credit

In 1999, the Illinois legislature enacted a school tuition subsidy in the form of a non-refundable credit against educational expenses in excess of \$250.

Here's how the credit is calculated: for each dependent student in a K-12 public or private school in Illinois, a taxpayer adds up the amounts paid in tuition, book fees for required books, and lab fees. If the total amount of qualified education-related expenses is less than \$250 in any year, the credit is not allowed. The credit is calculated as 25% of expenses *over* \$250, with a maximum credit of \$500. Two features of the Illinois credit act to

minimize its usefulness for low-income families: the restriction of the credit to expenses over \$250 per year, and the non-refundability of the credit.

- More than half of the poorest Illinois families with children are entirely ineligible for the education credit. Of the 12 percent of Illinois families with children earning less than \$15,000 in

2000, 53 percent have no income tax liability after the property tax credit and are therefore ineligible for any credit amount. And virtually none of these taxpayers paid enough income taxes in 2000 to be eligible for the maximum education credit of \$500.

- The \$250 minimum expense requirement means that most families with children in public schools will probably be ineligible for the credit as well. In a suit challenging the constitutionality of the Illinois education credit in the fall of 2000, plaintiffs estimated that public school students pay tuition, book fees and lab fees of less than \$40 per student, on average.
- Since better-off families are much more likely to send their children to private schools, the \$250 minimum requirement acts to tilt the distribution of the tax cuts in favor of wealthier taxpayers with children.

### Families with Kids Ineligible for the Education Credit

#### Illinois Families with Children in 2000

Income Range:	% of Returns	% With No PIT Liability	% With Positive PIT Liability <\$500	% Unable to Claim Maximum Credit
Under \$15,000	12%	53%	47%	100%
\$15,000 to \$30,000	17%	7%	64%	71%
\$30,000 to \$50,000	19%	2%	11%	13%
\$50,000 to \$75,000	22%	0%	2%	2%
\$75,000 to \$100,000	12%	0%	0%	1%
\$100,000 to \$200,000	13%	0%	0%	0%
Over \$200,000	4%	0%	0%	0%

**Notes:** The credit provides a maximum tax credit of \$500 per family in 2000. Only expenses over \$250 can be claimed toward the credit. This means that only families with annual education expenses of \$2,500 (\$2,250 of eligible expenses, plus the first \$250 of expenses, which are ineligible for the credit) are eligible for the maximum credit.

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improvement for Illinois over the previous year, when the state taxed these families at a lower level than all but *three* other states. The improvement was entirely due to the state's enactment of an Earned Income Tax Credit for tax year 2000. If the EITC is allowed to sunset in 2003 (as the enacting legislation provides), the state's ranking will decline again.

In addition, the education credit is estimated to be quite costly: it reduced income tax collections by over \$60 million in tax year 2000. By comparison, \$60 million could have funded a \$1000 income tax credit for each child under 12 in 2000.

### Social Security Exclusion

Like the 36 other states that use federal adjusted gross income (AGI) as the starting point for calculating income tax, Illinois includes a portion of Social Security benefits in Illinois gross income. Under federal tax rules, Social Security benefits are exempt if the taxpayer's income is below \$32,000 for married couples (\$25,000 for other taxpayers). Taxpayers with income exceeding these thresholds pay some tax on Social Security benefits.<sup>5</sup> However, Illinois departs from the federal definition of AGI by allowing taxpayers to subtract any and all Social Security income that is taxable for federal purposes. Both the federal exemption and the Illinois exemption tend to benefit wealthier elderly taxpayers. The Illinois-specific exemption, however, is especially regressive—and quite costly.

- The wealthiest 10 percent of elderly Illinois taxpayers receive more than half the benefit from the Illinois exclusion—and the poorest 50 percent of elderly Illinois residents receive one-tenth of one percent of the benefit. The Illinois exclusion is such a bad deal for most elderly Illinoisans because of the generous exemptions already allowed by the federal government for Social Security benefits.
- Only 26 percent of Illinois Social Security beneficiaries would pay Illinois income tax on their benefits if the special Illinois exemption were repealed—which means that only 26 percent of elderly taxpayers receive a break from the Illinois exemption.
- And of the 70 percent of elderly taxpayers earning less than \$50,000 in 2000, only about 5 percent receive a tax break from the Illinois exemption.

Illinois	Retirement Income Exclusions	
	Pension	Social Security
	<b>All exempt</b>	<b>All exempt</b>
Iowa	\$5,000 (\$10,000 married filing jointly)	Federal pre-1993 rules
Indiana	\$2,000 exempt	All exempt
Kentucky	\$35,000 private, full exemption for public	All exempt
Michigan	\$32,880 private, full exemption for public	All exempt
Missouri	\$6,000 means-tested exemption	Federal pre-1993 rules
Wisconsin	None Exempt	Federal pre-1993 rules

### Other Pension Benefits

Illinois is quite generous in its tax treatment of private and public pension income other than Social Security benefits. Alone among Midwestern states levying an income tax, Illinois exempts all pension income from taxation. This blanket exemption creates two glaring problems of equity: first, it provides a special exemption to elderly taxpayers at all income levels.

### Effect of Eliminating Pension and Social Security Benefit Preferences

Elderly Illinois Residents by Income Group, 2000

Income Range	% of taxpayers in group	Average Income	% of Tax Hike From Taxing:	
			Pensions	Social Security
Below \$15,000	22%	\$ 10,000	0.6%	0.0%
\$15,000-\$30,000	28%	\$ 22,000	10.5%	0.1%
\$30,000-\$50,000	20%	\$ 38,000	21.8%	4.6%
\$50,000-\$100,000	19%	\$ 69,000	42.1%	40.2%
\$100,000 or more	10%	\$ 307,000	25.1%	55.1%
<b>Addendum: Bottom 50%</b>		<b>\$ 16,000</b>	<b>11.0%</b>	<b>0.1%</b>

The pension benefits of the wealthiest executive receive the same favored treatment as do the benefits of

<sup>5</sup>For taxpayers with income above these thresholds, but below \$44,000 (\$34,000 for single filers), 50 percent of Social Security benefits contributing to adjusted income above these thresholds are subject to tax at the 3 percent rate. At very high income levels (above \$44,000 for married couples), 85 percent of benefits are subject to tax.

the lowest-paid worker. A second, more fundamental inequity in this approach to elderly tax relief is that it provides special treatment for non-working taxpayers, with no comparable exemption for the earned income of otherwise identical seniors. Over-65 workers who are employed out of necessity are completely excluded from this generous tax break. Since elderly Illinoisans who work tend to be poor, this tax preference for unearned income—with no corresponding preference for earned income—is hard to justify. The “Options” section of this report shows that a revenue-neutral change eliminating these tax preferences and using the revenue to increase elderly exemptions would cut taxes for 60 percent of elderly taxpayers, and would *cut* federal income taxes paid in Illinois by \$35 million.

These poorly targeted exclusions reduced Illinois income tax collections by over \$500 million in 2000—and the gradual aging of the Illinois population suggests that as retirement benefits become an increasingly large component of total personal income in Illinois, the blanket exemptions granted to pension and Social Security income under the state’s tax code will force the state to turn to the other, currently taxed sources of personal income for additional revenues. In addition to creating a source of inequity between elderly taxpayers whose income is derived from these preferred sources and those whose income takes the form of wages, these preferences also discriminate against low-income taxpayers under the age of 65—and make it more likely that future income tax hikes will fall disproportionately on the non-elderly.

### Still a Low-Income Tax State?

This chapter has presented data suggesting that in the aggregate, the Illinois income tax burden is among the lowest among state levying such a tax. Yet the regressivity of the tax suggests that the state’s tax burden ranking may vary by income group. The chart at right compares the tax burden as a percentage of Illinois income for Illinois and each of the surrounding states in 2000: in other words, the chart shows the impact of imposing seven different state income taxes on Illinois taxpayers in 2000. The results are striking: while the overall Illinois tax burden ranks seventh highest—dead last—in this group of seven states, the state tax burden on the poorest twenty percent of Illinoisans is actually second *highest*, trailing only Indiana. By contrast, the Wisconsin tax burden is the highest among the seven in the aggregate, but places the second *lowest* tax burden on the poorest taxpayers. And none of the surrounding states require the very poorest taxpayers to pay as large a share of the state income tax burden as does Illinois.

**Regional Rankings: Income Tax Burden in 2000**  
Tax Burden on Illinois Taxpayers in 2000

	IL	KY	IA	MO	IN	WI	MI
Lowest 20%	2	3	4	7	1	6	5
Second 20%	6	1	4	7	2	3	5
Middle 20%	7	2	3	6	4	1	5
Fourth 20%	7	2	3	4	5	1	6
Next 15%	7	2	3	4	6	1	5
Next 4%	7	2	3	4	6	1	5
Top 1%	7	2	1	3	6	4	5
<b>All Taxpayers</b>	7	2	3	4	6	1	5
<b>% of tax paid by poorest 20% (Rank)</b>	1	3	4	7	2	6	5

SOURCE: ITEP Tax Model

### A Low-Growth Tax

The overall regressivity of the Illinois income tax has consequences beyond its direct effort on lower-income tax burdens: it also depresses the overall growth rate of the tax—which makes it harder for Illinois to provide state services in times of fiscal crises. The Illinois income tax grows more slowly than almost every other state income tax. Controlling for the effects of legislated income tax changes, one study found that the long-term growth rate of the Illinois income tax was the lowest in the nation during the period from 1976 to 1995.<sup>6</sup> In general, flat-rate income tax states experience slower income tax growth than more progressive states. This is because progressive income taxes tend to place a higher marginal tax burden on the wealthiest taxpayers—and most of the recent growth in personal income has been concentrated at the top

<sup>6</sup>Dye, Richard F., and Therese J. McGuire, 1998. “Block grants and the sensitivity of state revenues to recession.” *1997 Proceedings of the National Tax Association*. Washington DC. Dye and McGuire found that the Illinois tax had a long-term elasticity of 0.95.

of the income scale. States that tax their wealthiest citizens at lower or flat rates, like Illinois, are less able to capture personal income growth in the form of increased tax collections.

Under a progressive rate structure, for each dollar of growth in personal income, *taxable* income generally grows by more than a dollar. This is because most features of state tax systems—including rate brackets and statutory tax exemptions, such as standard deductions, personal exemptions, and “targeted” tax exemptions for particular types of income such as pensions, Social Security, and capital gains-- are fixed in dollar value. In states that do not index these exemptions, there is an inexorable tendency toward “bracket creep” which gradually makes a greater percentage of total income subject to tax, and increases tax revenues without requiring explicit legislation.

In general, the best way to make personal income tax revenues more stable over time is to broaden the base as much as possible. Certain components of income—in particular, retirement income, which isn’t affected by economic downturns—tend to be quite stable over the business cycle, and excluding these components of income from the income tax base adds to the instability of the tax.

The 1990s were a period of rapid growth in state income taxes. Yet the “natural” growth of the Illinois tax—that is, after controlling for all legislated tax changes—was lower than almost all other income taxes nationwide. And the “natural growth” of the tax was diminished by changes enacted during the decade.

The chart at right shows the natural growth rate of the Illinois tax during the 1990s under 2000 law, as it stood in 1989, and under several alternative scenarios. Changes enacted during the 1990s actually increased the yield of the income tax marginally. Yet eliminating regressive income tax breaks would have increased the growth rate of the tax during the 1990s, as would the imposition of a higher flat income tax rate of 5 percent. By contrast, eliminating the state’s Earned Income Tax Credit would have *diminished* the growth rate of the Illinois income tax, because incomes grew most slowly among taxpayers receiving the credit.

## Approaches to Income Tax Relief

In recent years, many states have moved to decrease the income tax burden paid by low-income taxpayers. The inclusion of poverty-stricken taxpayers in the income tax rolls, once the rule among states levying such taxes, is now the exception.<sup>7</sup> Two of the most common strategies for low-income tax relief employed by states are low-income credits such as the Earned Income Tax Credit and dependent care credits, and indexing features of the income tax for inflation.

### Earned Income Tax Credit

An increasingly popular means of achieving state tax relief for the working poor is an Earned Income Tax Credit (EITC). The federal EITC is designed to provide targeted tax relief to low-income working taxpayers. Because it is calculated as a percentage of earned income, the EITC acts as a work incentive for low-income taxpayers. In tax year 2000, fifteen states allowed a state EITC modeled on the federal credit.

State Earned Income Tax Credits in 2000			
		Credit	Refundable?
Colorado		10%	Yes
D.C.		10%	Yes
Illinois		5%	No
Iowa		6.50%	No
Kansas		10%	Yes
Maine		5%	Yes
Maryland		50%	Yes
Massachusetts	202%	10%	Yes
Minnesota	194%	15 to 46%	Yes
New Jersey	202%	10%	Yes
New York	202%	22.5%	Yes
Oregon	202%	5%	No
Rhode Island	202%	26%	No
Vermont	200%	32%	Yes
Wisconsin	200%	4-4.3%	Yes

**Note:** This chart shows the growth in income tax revenues if different tax systems were imposed, without changes, for the entire period from 1989 to 2000. **Notes:** Maryland also allows a refundable 10% credit. The Massachusetts credit will increase to 15% in 2001. The New Jersey credit will increase to 20% in 2003. The New York credit will increase to 30% in 2003.

<sup>7</sup>State Income Tax Burdens on Low-Income Families in 2000: Assessing the Burden and Opportunities for Relief. Center on Budget and Policy Priorities, 2000.

Most of these state credits are, like the federal credit, *refundable*. This means that low-income taxpayers are paid any EITC in excess of their pre-credit tax liability. Thus, the EITC allows low-income taxpayers with little or no income tax liability to claim the full EITC to mitigate the effect of regressive sales and excise taxes. Because the benefits of the EITC phase out above a specified income level, the credit is targeted to the working families who need it most, and the cost of the credit is kept to a minimum. Six states—including Illinois—allow only a *nonrefundable* credit, which means that the credit claimed cannot exceed income tax liability in a given year. Non-refundability limits the usefulness of the EITC as a work incentive for those with little or no income tax liability. Because the Illinois credit is nonrefundable, many low-income taxpayers receive less than the full amount of the credit.

The Illinois credit, enacted in 1999 for tax year 2000, is scheduled to sunset after tax year 2002. While this “sunset” is unusual among state EITC’s, it will force the state legislature to reconsider the generosity of the state credit over the next two years.

### **Dependent Care Credit**

As an increasing number of single parents take jobs—and as the number of two-earner families continues to increase—the increasing cost of child care may act as a work disincentive for these families. Since 1982, the federal government has attempted to reduce this disincentive by providing a tax credit for income taxpayers who incur costs of dependent care. The federal credit allow taxpayers to claim as much as 30 percent of these costs as a nonrefundable credit against income tax. The federal credit is a sliding-scale percentage of eligible expenses<sup>8</sup>, starting at 30 percent of expenses and gradually decreasing to 20 percent as income rises. Taxpayers at all income levels are available for the 20 percent credit. Because the federal credit is nonrefundable (that is, it can only be used to reduce federal income tax liability), its usefulness for low-income taxpayers is limited; because the credit is available even to the wealthiest taxpayers, its cost is somewhat higher.

In recent years, many states have enacted “piggyback” credits that start with the federal definition of “eligible child care expenses” and apply a lower percentage. Some states have also modified the federal credit by making it refundable—so that lower-income taxpayers with child care costs can take full advantage of the credit—and by instituting an income eligibility cutoff.<sup>9</sup>

### **Indexation**

Many features of personal income taxes are defined by fixed dollar amounts. For instance, a single Illinois taxpayer can claim a personal exemption of \$2,000 in tax year 2001. If these fixed amounts aren't adjusted periodically, taxes will increase regularly simply because of the effects of inflation—\$2000 in one year is worth less and less in following years. This phenomenon is known as "bracket creep." The same process tends to reduce the real value of other important features of the tax system over time as well.

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<sup>8</sup>Eligible expenses are limited to \$4,800 for joint filers and \$2,400 for single parents.

<sup>9</sup>For example, Colorado disallows its dependent care credit for all taxpayers earning over \$63,000.

In states that do not take account of the "bracket creep" problem, the existing tax structure in 2001 is likely to be significantly less progressive than it was when the exemptions, deductions and rate brackets were first set at their current value. The way the federal personal income tax code deals with this problem is by "indexing" these features of the tax code for inflation. This means that every year, the personal exemption, standard deduction and rate brackets are increased by the amount of inflation. Many states have followed the federal lead by indexing various parts of their tax structure for inflation: 19 of the 42 states (including Washington D.C.) with broad-based income taxes have passed legislation to index either exemptions, deductions, or tax brackets for inflation--and 7 states currently index all three of these factors. Indexation helps avoid "hidden tax hikes" on unsuspecting personal income taxpayers—and ensures that growth in income tax burdens will only take place when lawmakers explicitly decide that it should.

### Linking to the Federal Income Tax

Almost all states levying income taxes link the tax to the federal income tax structure, either by making federal income definitions the starting point for state calculations, or by calculating tax as a percentage of federal tax. Like most states, Illinois uses "Federal Adjusted Gross Income" as a starting point in defining gross Illinois income. Linking the Illinois tax base to the federal income tax base has several important implications for taxpayers and for policy makers:

- The administrative burden on taxpayers and on tax collectors is generally much lower. The complexity of state income tax calculation is usually inversely related to the degree to which the tax is linked to the federal income tax. One can imagine a hypothetical "postcard" Illinois tax return with just two lines—the federal tax paid by the taxpayer, and the result of a "percentage of federal" calculation in which each Illinoisan pays a flat percentage of their federal tax to the state. The "Options" chapter shows that this sort of simplifying change could be made in a way that leaves the aggregate amount of Illinois income taxes unchanged, cuts taxes for 70 percent of Illinoisans, and results in a windfall to Illinois taxpayers of \$360 million due to federal tax cuts for itemizers.
- On the other hand, the simplicity of the federal-based structure can only be preserved if state lawmakers agree to adopt tax reforms enacted by the federal Congress. For example, if Congress enacts a new deduction for long-term health care spending, Illinois lawmakers must either conform to the federal decision—which means a reduction in the Illinois tax base—or not conform to the federal decision, which means that Illinois taxpayers must take an extra step in calculating Illinois adjusted gross income. In the long run, the more Illinois decides to depart from federal income definitions, the less useful the federal linkage will be.

### States Indexing Their Tax Structure in 2000

State	Standard Deduction	Personal Exemption/Credit	Rate Brackets
Arkansas	N	N	Y
California	Y	Y	Y
Colorado	Y	Y	N*
Idaho	Y	Y	N
Iowa	Y	N	Y
Maine	Y	Y	Y
Michigan	N**	Y	N*
Minnesota	Y	Y	Y
Missouri	Y	N	N
Montana	Y	Y	Y
Nebraska	Y	Y	N
New Mexico	Y	Y	N
North Dakota	Y	Y	N
Ohio	N**	Y	N
Oregon	N	Y	Y
Rhode Island	Y	Y	Y
South Carolina	Y	Y	Y
Utah	Y	Y	N
Vermont	Y	Y	Y
Wisconsin	Y	N	Y
States Indexing	16	16	11

#### Addendum:

States (including DC) with Broad-Based Income Taxes: 42

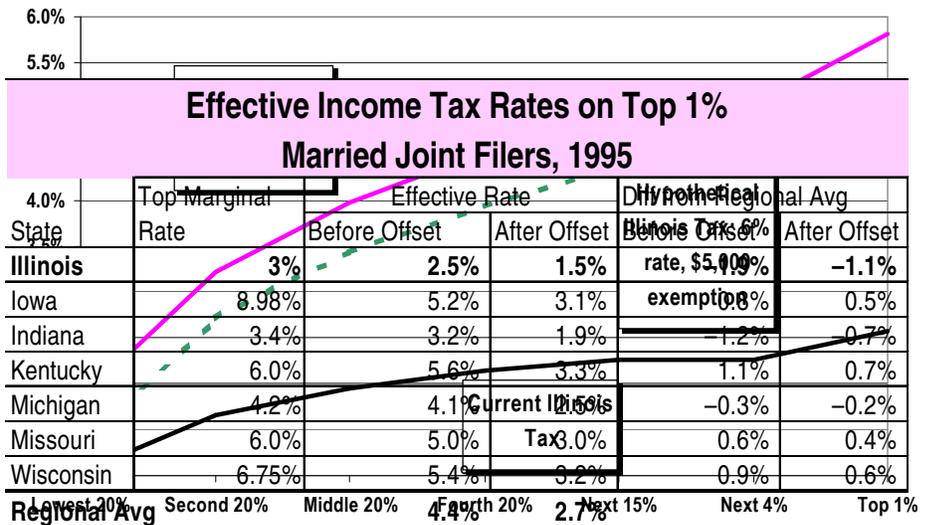
\* Levies a flat-rate income tax; indexing not possible

\*\*Does not allow a standard deduction

## Constitutional Limitations and the Illinois Income Tax

Like most of the states currently levying a flat-rate personal income tax, Illinois has enshrined its flat-rate tax structure in its constitution, which means that one of the most obviously effective means of making the state income tax more progressive—instituting a graduated rate structure—would require a constitutional amendment.<sup>10</sup> However, graduated rates are only one way of achieving a progressive income tax. If we think of the Illinois personal exemption as being equivalent to a “zero percent” rate on the first \$2,000 of income for single taxpayers, we can see that the use of exemptions and deductions achieves the same effect as a multi-rate structure—taxing lower income levels at lower effective rates.

### Achieving Progressivity with a Flat Tax: Income Tax as a % of Income Under Three Scenarios



This means that the constitutional limitations facing Illinois lawmakers do not stand in the way of instituting a tax system as progressive as any of its neighbors. Wisconsin’s income tax, for example, is much more progressive than the Illinois tax structure. Yet Illinois could modify its income tax to mirror the progressivity of the Wisconsin tax without actually departing from its current flat-rate structure. The following chart shows the effective tax burden under the Wisconsin and Illinois income taxes in 2000—and the effective tax burden under a modified Illinois income tax with an increased flat rate of 6 percent and an increased personal exemption of \$5,000. Increasing the flat rate while also increasing the personal exemption would make the incidence of the Illinois income tax quite similar (although slightly lower, in the aggregate) to that of the current Wisconsin graduated rate structure.

### Interaction Between Illinois and Federal Income Taxes

A common area of focus in comparing the tax structure of neighboring states is the top marginal tax rate paid on personal income. Arguments have persistently been made by anti-tax activists that high marginal tax rates tend to depress economic growth.<sup>11</sup> However, focusing only on the marginal state income tax rates in each state tends to overestimate the real difference in tax rates between states. The reason that interstate income tax rate differentials are never as large as they appear has to do with the interaction between state and federal income taxes. Because the state personal income tax is deductible from the federal income tax, the real differences between state top marginal rates are even smaller than they appear.

This can be dramatically illustrated by reference to the states surrounding Illinois. The chart at right shows the top marginal rate facing taxpayers in each state, the effective tax rate on the wealthiest 1 percent of taxpayers before the federal offset is taken into account, and the same statistic *after* the federal offset. The top marginal rate on income in Kentucky is 6 percent—3 percent higher than the single Illinois tax rate. But the *effective* top rate after the federal offset is taken into account is about half the nominal top rate in each

<sup>10</sup>Section 3 of Article 9 of the 1970 Constitution requires that “a tax on or measured by income shall be at a non-graduated rate.”

<sup>11</sup> *The Case Against a Tennessee Income Tax*, Cato Institute, 1999. For a response, see “High Income Tax States have Strong Economies,” on the ITEP website at <http://www.ctj.org/itep/tncatopr.htm>.

state. This is because those who itemize on their federal tax returns can deduct state income taxes, the real difference in income tax burden between wealthy taxpayers in Kentucky and Illinois is substantially less than the nominal rates—or even the effective rates before the federal offset—would make it appear. In other words, paying more state tax lowers taxpayers' federal tax, which makes the effective rate of the state tax less. For a top-bracket federal taxpayer in Kentucky, the 6 percent top state rate is really only about a 3.3 percent rate after accounting for the lower federal tax. The 3 percent rate in Illinois equates to a 1.5 percent effective top marginal rate. So the difference between the tax rates in Illinois and Kentucky, in terms of their real impact, is actually only 1.8 percentage points—much less than the 3 percent difference one would infer from comparing the state tax rates.

This “smoothing” effect of the deductibility of state income taxes on federal tax forms is one of the most important—and least understood—factors that determining the real impact of a state income tax on its citizens. This feature is a good deal for states like Wisconsin and Minnesota that rely heavily on income taxes, because it allows states with progressive income taxes to “export” part of their tax burden to the federal government. Conversely, the federal offset is an especially *bad* deal for states like Illinois, because the state loses the ability to “export” a substantial part of its tax burden to the federal government.

## Conclusion

Illinois is less reliant on the personal income tax as a source of revenue than almost all of the 41 states currently collecting broad-based income taxes. The state's income tax is also one of the *highest* income taxes on poorer taxpayers. Each of these seemingly contradictory findings stem from the same underlying structural problems in the state's income tax: the flat-rate structure of the tax, the relatively small amounts of targeted low-income relief that is delivered through personal exemptions and the state's Earned Income Tax Credit, and the poor targeting of various other exemptions and credits which serve to erode the state income tax base.

By disproportionately balancing the state's income tax on the backs of its poorest citizens, Illinois hampers its own ability to capture the gains from economic growth—and fails to take advantage of the interaction between state and federal taxes. Progressive reform of the income tax would revitalize the state's revenue collections—and would be subsidized in the form of federal tax cuts.