

TAX FACTS



Taxpayers' Federation of Illinois

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GRADUATED INCOME TAX VIEWED FROM A TAX POLICY PERSPECTIVE

By Dr. Natalie Davila

Natalie Davila is an economist with an extensive background in public finance. She was Director of Research for the Illinois Department of Revenue for 10 years.

President's Foreword

The effort to amend the Illinois Constitution to allow graduated income tax rates has stalled for this year, but I suspect that it will return. When it does, I hope that the debate will focus on sound tax policy, and this article identifies policy guidelines for advocates and opponents to consider. Of particular interest, and receiving scant attention to date, are: [1] the greater volatility of tax revenues under graduated rates, [2] the question of relative reliance on personal income taxes, [3] the increased costs (for taxpayers and for the government) to administer a more complex graduated rate system, [4] the question of whether single and joint filers should be taxed at different rates, and [5] whether economic distortion would occur under graduated rates. A discussion incorporating these policy issues would be more productive than merely the simplistic arguments that a graduated tax would, or would not, be "fair". – Carol Portman,

INSIDE THIS ISSUE

Notes from the Inside6

Does Illinois Have a Revenue Problem or a Spending Problem?12

Taxable Property Values Decline for a Record Third Consecutive Year18

TFI 73rd Annual Meeting20

CONTACT US:

430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818
F. 217.522.6823
www.iltaxwatch.org
tfi@iltaxwath.org

Introduction

Given recent and likely future conversations about a progressive income tax in Illinois, this article takes a step back from specific proposals and instead summarizes arguments associated with a progressive versus a flat rate income tax structure and closely examines how progressive income taxes are structured in other states.

Progressive versus Flat Rate Taxation

In theory, a flat rate is exactly that - no exemptions, deductions or credits. Everyone pays the statutory rate. A progressive income tax system is more complex, has differing statutory tax rates depending on income levels, and various exemptions, credits and other income modifications that cause deviations between the statutory rate and the effective rate. In theory:

- A progressive or a flat tax can be considered adequate and balanced depending on the rate and resulting revenue mix.

- A progressive tax is more likely to distort economic behavior when compared to a flat tax.
- A flat tax achieves horizontal equity where a progressive income tax achieves vertical equity.
- A flat tax is more likely to meet the principle of simplicity when compared to a progressive tax.
- Receipts from a progressive tax are more volatile than receipts from a flat tax and as such require greater fiscal discipline.
- Everything else being equal, a broad-based tax will have a lower rate and minimize economic distortions.

However, reality differs significantly from theory. States with flat statutory tax rates have income modifications such as exemptions, additions, subtractions, and credits that are in some part designed to make the tax system more progressive. These tax systems often have credits earned by partners and shareholders of businesses that are taken

Four Economic Principles of Tax Policy

Adequacy: The tax system should generate sufficient revenues to pay for government spending. The adequacy principle does not provide any guidance on what the level or mix of government spending should be.

Economic Neutrality (Efficiency): Taxes should minimize distortions in economic behavior.

Equity (Fairness): Equity has two dimensions – Horizontal equity, where similarly situated individuals pay similar taxes, and vertical equity, where individuals' tax burdens reflect their ability to pay.

Simplicity: Taxes should be designed to minimize taxpayers' cost of complying with the tax and the government's cost of administering it.

TABLE 1. Effective Income Tax Rates in Illinois, Tax Year 2011

Net Income Range	Returns	Effective Rate Rate (A)	Effective Tax Rate Accounting for Taxes Paid in Other States (B)	Effective Tax Rate adding Back Retirement Income (C)	Effective Rate Adding Back Retirement Income & Accounting for Taxes Paid in Other States (D)
Equal or Less than Zero	725,350	N/A	N/A	N/A	N/A
\$1 - \$25,000	2,356,177	4.2%	4.2%	2.8%	2.8%
\$25,001 - \$50,000	1,142,097	4.6%	4.7%	4.1%	4.1%
\$50,001 - \$75,000	673,689	4.6%	4.7%	4.3%	4.4%
\$75,001 - \$100,000	405,073	4.6%	4.7%	4.4%	4.5%
\$100,001 - \$250,000	562,265	4.6%	4.8%	4.4%	4.6%
\$250,001 - \$500,000	84,392	4.7%	4.8%	4.5%	4.7%
\$500,001 - \$1,000,000	27,366	4.6%	4.9%	4.5%	4.7%
\$1,000,001 or more	14,667	4.5%	4.9%	4.4%	4.8%

Source: Illinois Department of Revenue, Report TDWR-IITEOY-002.

Note: We assume that Illinois will always provide a credit for taxes paid in other states, rather than legislate double taxation.

on their individual income tax return, further impacting the effective rates.

Is Illinois' Income Tax Flat?

In order to assess these two approaches from a tax principles' standpoint, we must first examine the reality of a flat rate to determine how, in practice, it holds up to these principles. To do this, we use Illinois as a case study to determine how its current individual income tax structure measures up to the theoretical ideal of a flat tax system.

Table 1 illustrates several measures of effective individual income tax rates in Illinois:

Column A calculates effective tax rates by dividing taxes due net of all credits by net

income (the income that the tax rate is applied to). The data illustrates that, on the surface, the 5 percent tax rate becomes modestly progressive at low net income levels, but the effective rate begins to flatten out at income levels of around \$25,000. Taken together, on average credits act to make the current Illinois tax rate more progressive. Schedule 1299-C (business) credits tend to make the tax code regressive, whereas the property tax, education, and earned income tax credits introduce modest progressivity into the tax code.

Column B takes into account income taxed by other states which is not taxed by Illinois. (e.g. a Metro East resident who works in Missouri

pays taxes to Missouri on that income, but is not double taxed by Illinois.) The column reflects the principle in the Illinois tax code that income should not be taxed twice and the data show out-of-state income is heavily earned by higher income taxpayers.

Column C recognizes that retirement income is currently exempt from taxation in Illinois, and as a result is not included in existing net income figures. We add the untaxed retirement income to net income and calculate effective tax rates that include retirement income to give some indication of how the retirement income subtraction impacts the progressivity of taxation in Illinois. The retirement income subtraction increases progressivity until income levels of \$700,000 or more.

Column D combines columns B and C. In a sense, this column provides the best perspective as it takes into consideration the impact of tax credits, the exemption of retirement income, and taxes paid to other states. The effective tax rate under this scenario is moderately progressive.

The above analysis illustrates that in spite of Illinois having a flat statutory tax rate, the actual tax code introduces elements of progressivity and regressivity resulting in tax rates that are below the statutory rate and vary by net income levels. Therefore, it is an oversimplification to refer to Illinois as a flat tax state.

By introducing income modifications into the tax code, some sound tax policy principles typically associated with a flat tax are violated. First, offering credits and exemptions favors certain behavior over another, undermining economic neutrality. Second, the ability to claim and use credits reduces horizontal and vertical equity, as does the retirement income subtraction. For example, the property tax credit treats those that own property differently than those that rent. One of the main attributes cited for a flat tax is simplicity in terms of administration and compliance. Introducing income modifications to the tax code increases complexity both in terms of administration and compliance. In other words, Illinois' tax system is something of a hybrid—it looks somewhat like a progressive system not only in its effective rates, but also when viewed through the lens of sound tax policy principles.

There are several “rules of thumb” in tax policy that should also be considered in examining Illinois' individual income tax: a balanced revenue system; broad base and low rates; and predictability or stability [**see the box on page 5**]. In terms of a balanced tax structure, prior to the 2011 income tax rate increase, Illinois was slightly higher than the national average in terms of income tax contributions to total state taxes (43.6 percent in Illinois compared to 39.0 percent nationally).¹ However, the 2011 tax rate increase means that Illinois currently relies much more heavily on these sources. In 2013, income taxes made up 54.2 percent of all state taxes in Illinois,

compared with 41.9 percent nationally. In addition, Illinois' individual income tax base is not as broad as it could be due to the retirement income exemption. Finally, revenue under progressive tax rates fluctuates more widely with the economic cycle.² A flat rate will result in a relatively more stable revenue stream. Having said that, it should be noted that certain income modifications (credits that move with the business cycle) may slightly increase volatility.

deliberating the merits of a progressive income tax in Illinois.

Factors to Consider when Structuring a Progressive Income Tax

For purposes of discussion and context, this report looks at individual income tax structures throughout the country and categorizes them based on general characteristics including: whether they have single or multiple tax rate schedules, the number of income bands and tax rates associated with each income band. We

Rules of Thumb for Tax Policy

Balanced Revenue System: State and local governments should not rely too heavily on one source of income. In Illinois, currently more than 50 percent of general funds revenue is derived from the individual income tax.

Broad Bases and Low Rates: The general consensus is that taxes should have a low rate and apply that to a broad base. This approach supports the principle of neutrality and allows for more predictability in revenue streams. Broad-based taxes can also produce relatively stable tax revenues from year-to-year. Receipts from a progressive tax rate structure are more volatile than receipts under a flat tax.

Stability/Predictability: Avoid short-term, unanticipated changes to the tax code; when tax laws are in flux, long-range financial planning (for taxpayers and governments alike) is difficult.

As noted above, there are arguments that can be made both for and against amending Illinois' constitution to allow departure from the statutory flat rate. The next section of the report provides a brief overview of income tax systems in surrounding states. The report concludes by outlining various principles and factors stake-holders should consider when

calculate single and married schedules based on the fact that most states that have progressive income tax structures have schedules for married filers that are double that for single filers.³ Summary results are as follows:

NOTES FROM THE INSIDE. . .

By Carol S. Portman

This issue of Tax Facts addresses two of the major questions confronting Illinois' state finances. (1) Should Illinois change its constitution and allow the income tax to be imposed at a graduated rate? And (2) What is driving the current fiscal crisis, a tax code that does not generate sufficient funds to meet needs, or an appetite for spending that we have been unable to curtail?

On the question of the income tax, I think the article by Natalie Davila articulates the policy considerations that must be addressed when this debate resumes. An open and thorough consideration of the underlying policy issues will provide a clearer understanding of the risks and benefits of changing our income tax to lawmakers and the voters of Illinois, who will ultimately be entrusted with the decision on whether to change our system of income taxation.

There is a significant tie between Natalie's piece on the graduated income tax and the second major article that asks the elemental question: "Does Illinois have a revenue problem or does it have a spending problem?" It is clear from that piece that the state's biggest problem has been matching available revenues to spending – we have avoided making the difficult choices to either raise taxes or cut spending (or some combination of the two). And, as this issue of Tax Facts goes to press, it appears that FY2015 will see more of the same.

- Thirty-four states have a progressive income tax rate.
- Of the 34 with progressive income tax, 22 have different income schedules that vary with filing status. Should a state have only one income schedule, it means that joint filers are treated in a manner similar to single filers. For example, under a system where a progressive income tax rate of 7 percent kicks in at \$100,000, a single person earning 90,000 will not be impacted. On the other hand, a married couple each earning \$90,000 will have \$80,000 of their income taxed at the 7 percent rate.
- Of the 22 states that have different income schedules, 12 have schedules that treat income bands associated with different rates for married returns at double than that of single returns.
- Of those that have progressive income tax rates, 14 index brackets for inflation.
- The average personal exemption for states with progressive income tax structures and exemptions is \$2,788, while the average exemption for dependents is \$2,399.

The analysis in **Table 2** synthesizes information on characteristics of states that have progressive income tax structures. Our approach is to calculate the average tax rate and income level associated with the lowest and highest average for the selected states. Once this range has been established, average income brackets and tax rates within the

TABLE 2. Summary of Progressive Income Tax Characteristics for All States With a Progressive Individual Income Tax

Single - Low End of Range	Single - High End of Range	Married Filing Jointly - Low End of Range	Married Filing Jointly - High End of Range	Rate
\$0	\$9,447	\$0	\$18,896	2.31%
\$9,448	\$43,809	\$18,897	\$87,619	3.25%
\$43,810	\$78,171	\$87,620	\$256,342	4.19%
\$78,172	\$112,532	\$156,343	\$225,065	5.13%
\$112,533	\$146,894	\$225,066	\$293,789	6.07%
\$146,895		\$293,790		7.01%

Note: the table assumes only two income schedules-single and married. We calculate the income schedules for married filing jointly at double that of singles, since this is the most common among the states that have more than one schedule.

range are calculated by dividing the difference between the maximum and minimum income and tax rates by the average number of income brackets for the selected states.

On average, progressive income tax states have 6 different income brackets and associated tax rates. The lowest average tax rate is 2.31 percent for taxable income up to \$9,447 for single filers, while the highest average tax rate is 7.01 percent for taxable income above \$146,895 for single filers. The average personal and dependent exemption for this group was \$2,788 and \$2,399 respectively. Generally, results were similar when analyzing the 4 surrounding states with progressive income tax structures, and states that have their highest tax rate at income levels of \$100,000 or more.

The above discussion illustrates that there are an infinite number of possible progressive in-

come tax scenarios that could be considered. Should an Illinois progressive income tax proposal gain momentum, it seems prudent for legislators and stakeholders to step back and examine how such income bands and associated tax rates should be developed. Issues, many of which have not yet been part of the debate, should include:

- What is the overall goal – how progressive do we want the state tax code to be?
- What should be considered “adequate” revenue from this source?
- Currently Illinois’ Individual Income Tax makes up more than half of Illinois’ general funds revenue. Some may consider this a revenue structure that is out-of- balance. The relative revenue contribution of each tax, as well as looking at burden for IIT alone, should be considered.
- What criteria should be used to develop the various income bands? Poverty level, average median income, *etc.* See **Table 3** on page 8 for guidance.
- Are income bands, and associated tax rates, for all returns or should there be different income bands depending on filing status? For example, some states with progressive income taxes have different schedules for single, married filing separately, married filing jointly,

TABLE 3. Illinois Income Statistics	Annual Amount
Poverty Level for 1 Person	\$11,670
EITC Income for 1 Person with no Qualifying Children	\$14,590
Wages for 1 Person Earning Illinois Minimum Wage (\$8.25)	\$16,500
Wages for 1 Person Earning Federal Minimum Wage on Federal Contracts (\$10.10)	\$20,200
Maximum Unemployment Benefit (annualized)	\$21,476
Median Household Income Divided by Average Number of Residents	\$21,700
Per Capita Income	\$29,519
Median Household Income	\$56,853

head of household, and surviving spouse. Under a single schedule system tax rates are applied per return and do not differentiate between returns with one or more than one taxpayer.

- Should income bands be linked to inflation?
- Should progressivity built into the rates include desired impact of income tax credits? Elimination of tax credits would make the tax return simpler, but eliminates other policy goals associated with the credits.
- How will higher tax rates impact small business shareholders and partners? Will the overall tax rate end up being higher for S-Corporations and Partnerships than for C-Corporations?
- Policy makers should recognize that progressive income tax revenue is more volatile to the business cycle. How should this be addressed in revenue

forecasting and budgeting? Should any revenue over a certain baseline be used only for one-time spending rather than on-going operations?

- Do progressive income taxes with significantly higher rates on higher income returns cause individuals to change their behavior and if so in what way? Increases in noncompliance, tax planning and out-migration are all possible responses, but to what

degree are they likely to occur? Research on the magnitude of such changes in behavior is mixed.⁴ However, any change in behavior resulting from higher rates would violate the tax policy principles of adequacy, simplicity, and neutrality. Alternatively a progressive income tax with no credits would advance the principles of horizontal and vertical equity.

Conclusions

Of note, our findings include:

- Progressive income taxes are more common than flat taxes.
- Revenue under a progressive tax structure moves more widely with the business cycle compared to revenue under a flat tax.
- The majority of states (65 percent) with a progressive income tax structure have more than one schedule that varies with filing status.

- The most common structure is to have two filing schedules, one for single filers and one for joint filers. Income levels for joint filers are double that for single filers.
- Many states with progressive income tax structures (41 percent) index income brackets for inflation.

come tax structures should recognize that both meet some of the principles of sound tax policy but violate others.

Illinois' current individual income tax structure is slightly progressive through net income levels of approximately \$1 million. Any conversation about flat versus progressive in-

ENDNOTES

- ¹ US Census of Government, <http://www.census.gov/govs/statetax/>, accessed April 28, 2014.
- ² See The Tax Foundation, The Great Recession and Volatility In Sources of Personal Income, <http://taxfoundation.org/article/great-recession-and-volatility-sources-personal-income>, accessed February 25, 2014.
- ³ Data Sources: Commerce Clearing House, 2013 State Tax Handbook; Federation of Tax Administrators, Individual Income Tax Rates, 2013.
- ⁴ The academic literature on this issue shows mixed results. For example, see: Cristobal Young and Charles Varner, Millionaire Migration and State Taxation of Top incomes: Evidence from a Natural Experiment, National Tax Journal, June 2011, 64 (2, Part 1), 255–284, www.stanford.edu/~cy10/public/Millionaire_Migration.pdf, accessed February 25, 2014, and Roger Cohen, Andrew Lai, and Charles Steindel, Tax Flight Has Tangible Effects On Income Tax Revenue, State Tax Notes, February 20, 2012, 617-622, www.state.nj.us/treasury/economics/documents/taxflight.pdf, accessed February 25, 2014 (article forthcoming in Public Finance Quarterly).

The Case for Looking at Average Tax Rates, Not the Marginal Rates

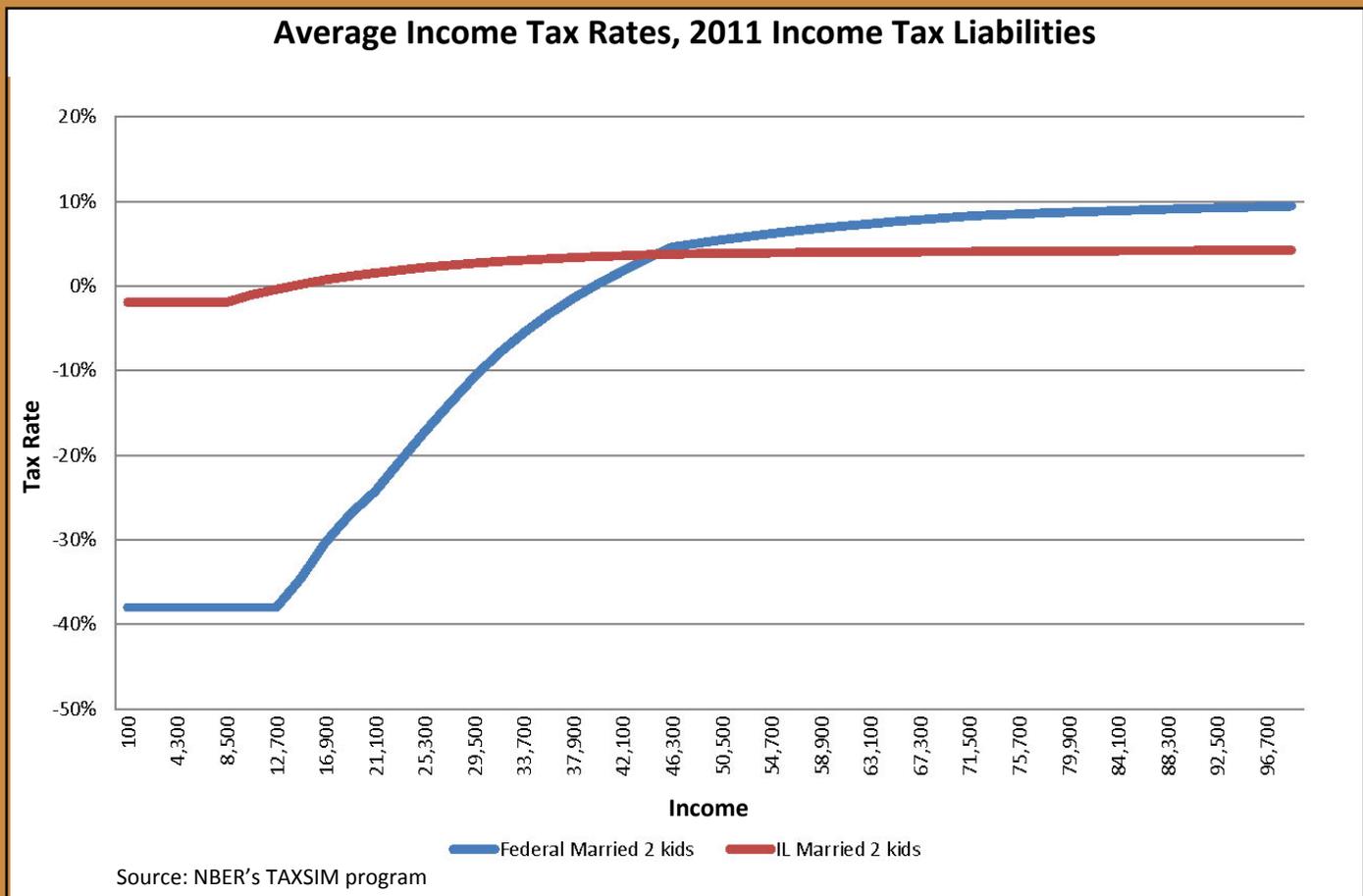
by Rob Ross

Robert Ross received his M.A. in Economics from the University of Illinois in 2013. His research focuses on local and state public finance, including property taxation.

How can we compare different graduated tax rates?

Graduated income tax structures can be confusing because they are presented in terms of marginal tax rates. Taxpayers, on the other hand, tend to think in terms of average tax rates. The marginal tax rate is the amount of taxes the government collects from every *additional dollar earned past a certain amount*. The average tax rate is the total amount of taxes the government collects, divided by total income. This can be calculated at the individual level, or at the population level, depending on the type of question being asked.

To illustrate the difference, consider a hypothetical tax scheme that applies a tax rate of zero on income from \$0 to \$50, and then a tax rate of 50% on income above \$50. In such a scheme, there are two *marginal* rates: 0% and 50%. The average rate is given by dividing total taxes by income, and up to \$50 in income, the average rate is 0%. At \$51 in income, the taxpayer pays \$0.50 in taxes; their marginal rate is



50% and their average tax rate is $\$0.50/\$1 = .01\%$. At $\$100$ in come the taxpayer pays $\$25$ in taxes; their marginal rate is still 50%, but their average tax rate is $\$25/\$100 = 25\%$.

For many purposes, the *average* tax rates have more probative value than the marginal rates. By plotting the average tax rate for a sample of taxpayers, we can compare states' entire tax codes, including the many deductions, credits, exemptions etc. that may affect taxpayers' tax liabilities.

Illinois' income taxes are already modestly graduated

Illinois tax code is a complex system of credits, deductions, exemptions, and many other features that make it difficult to judge exactly how "progressive" our tax code actually is. The state's current (as of 1/1/2015) statutory tax rate of 3.75% for all taxpayers is a "flat tax" because it applies equally to all taxpayers regardless of their income. Taking Illinois' *de jur* tax rate at face value, one might conclude that Illinois' income tax structure is not graduated at all. However, this is not true.

Through various features of the tax system, Illinois achieves a measure of progressivity in its income tax. Using the National Bureau of Economic Analysis' TAXSIM program, TFI calculated Illinois and federal tax liabilities for hypothetical filers. We then calculated average tax rates along a range of incomes from $\$0$ to $\$100,000$. The chart on page 10 plots the *average income tax rate* in Illinois against that of the federal tax system.

The chart shows three things. First, it shows that Illinois tax structure was modestly progressive in 2011. Second, it shows that the federal income tax structure is much more progressive than Illinois' tax structure, not just because of its graduated statutory rates but also because of the many refundable credits that push the average tax rate below zero percent for taxpayer making less than about $\$40,000$. In many cases, these refundable credits are a more powerful tool to achieve progressivity in an income tax structure than statutory rates are. Finally, the graph shows that the average tax rate does not actually reach the statutory tax rate of 5% below $\$100,000$ in income for this type of taxpayer.

¹ State taxes were calculated using the National Bureau of Economics Research's TAXSIM program. TAXSIM will calculate actual taxes due for years prior to 2012. We assumed equal division of income between married partners, 5% of income derived from other property income, mortgage interest payments of 5% of income and property tax payments of 7% of income.

DOES ILLINOIS HAVE A REVENUE PROBLEM OR A SPENDING PROBLEM?

By Mike Klemens

Mike Klemens does tax policy research for the Taxpayers' Federation of Illinois. He retired from the Illinois Department of Revenue in 2012.

The controversy over extension of the temporary income tax rate increases enacted in 2011 and scheduled to be partially rolled back on January 1, raises the classic question of Illinois state government finances: Does Illinois have a revenue problem or a spending problem? Some argue that the Illinois tax code is the problem and that it simply does not generate the money needed to provide services. Others suggest that Illinois has a spending problem and, further, that state taxes – particularly after the 2011 income tax rate increases – have acted to discourage economic growth.

At a glance

The question deserves a long-term view, so we look at a 20-year period, from 1993 through 2012, the latest year for which federal data on economic activity in Illinois is available.

Between 1993 and 2012 the relative increases were:

59 percent Inflation (the Consumer Price Index)

117 percent Personal income in Illinois (defined the income received by

all persons from all sources as calculated by the U.S. Bureau of Economic Analysis)

117 percent State Gross Domestic Product in Illinois (defined as the value of all the goods and services produced in Illinois as calculated by the U.S. Bureau of Economic Analysis)

126 percent Illinois general funds revenues

149 percent Illinois all appropriated funds cash receipts

Note: Revenue growth should be expected to grow faster than personal income because it reflects inflation, growth in the economy and the periodic “revenue enhancements” that occurred during the period.

133 percent General funds spending

146 percent All appropriated funds warrants issued

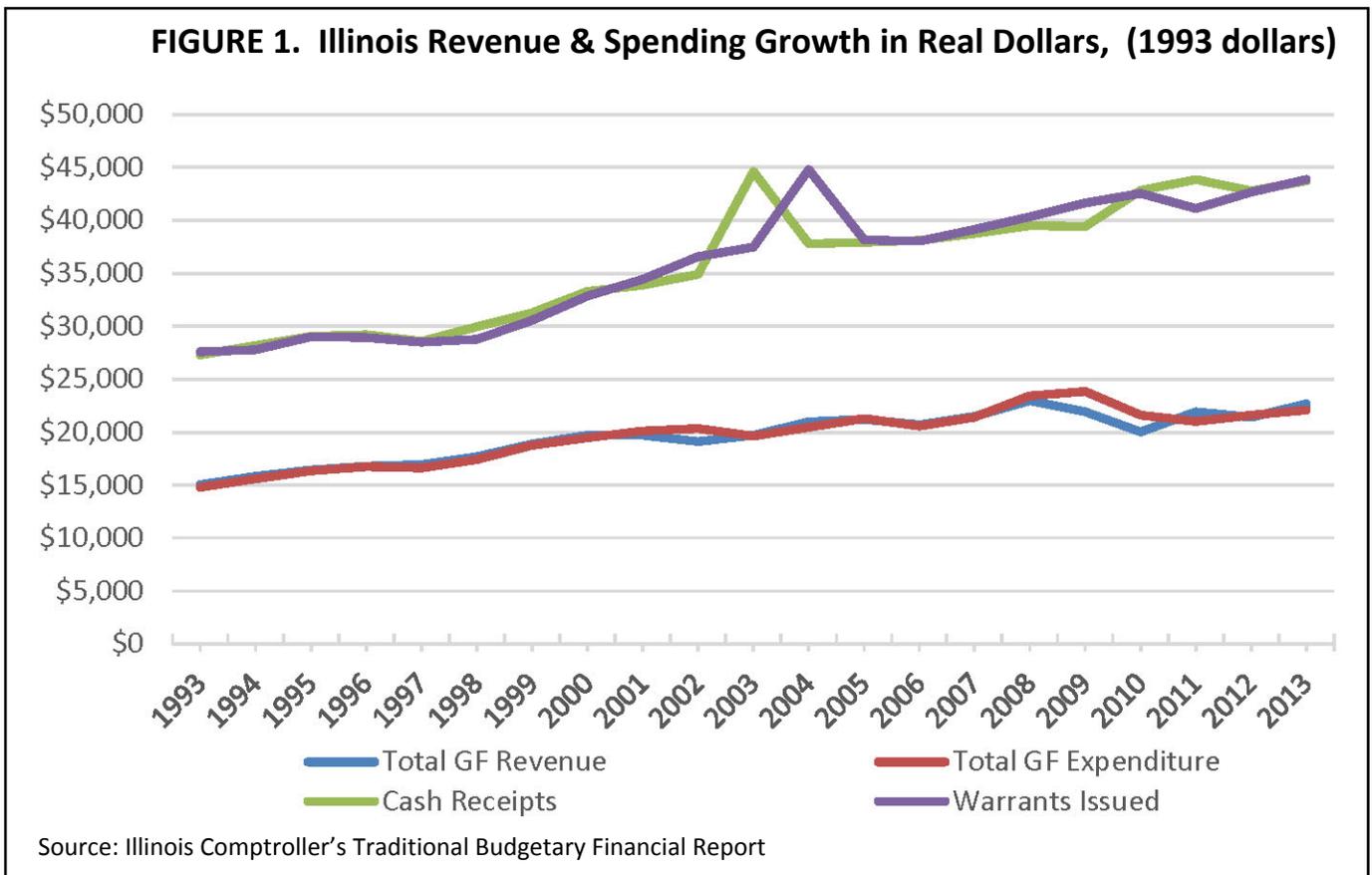
The significant income tax rate increases in 2011 (67 percent for individuals and 46 percent for corporations) boosted both the 2011 and 2012 revenue and spending numbers, but did not change the overall

pattern. Illinois revenues and spending – both in the general funds and in the broader all appropriated funds – grew faster than the rate of inflation, and faster than the Illinois economy.

Figure 1 shows the growth in 1993 dollars of revenues and spending, both in the general funds and in all appropriated funds. (All appropriated funds are the 500 plus funds from which the General Assembly makes appropriations, including the four general funds.) In real (inflation adjusted) dollars revenues and spending have increased consistently since 1997, with greater growth in the all appropriated funds. The prominent 2003 and 2004 spikes in all appropriated funds reflect the \$10 billion pension bond issue.

Figure 2 on page 14 illustrates Illinois spending and revenue as a percentage of its total economic activity, its State Gross Domestic Product (or Gross State Product). In both the general funds and all appropriated funds, revenues are taking a larger share of Illinois’ economic activity, but the growth is larger outside the general funds. See “Why Ignore Over Half of the Illinois State Budget Picture,” *Tax Facts*, May/June 2012.

The data indicate that both revenue and spending grew faster than inflation, faster than the income earned by Illinois residents, and faster than the value of goods and services produced in Illinois. This is true for both the general funds and for the broader all appropriated funds into which some spending has been shifted. To say that Illinois has exclusively a revenue problem one



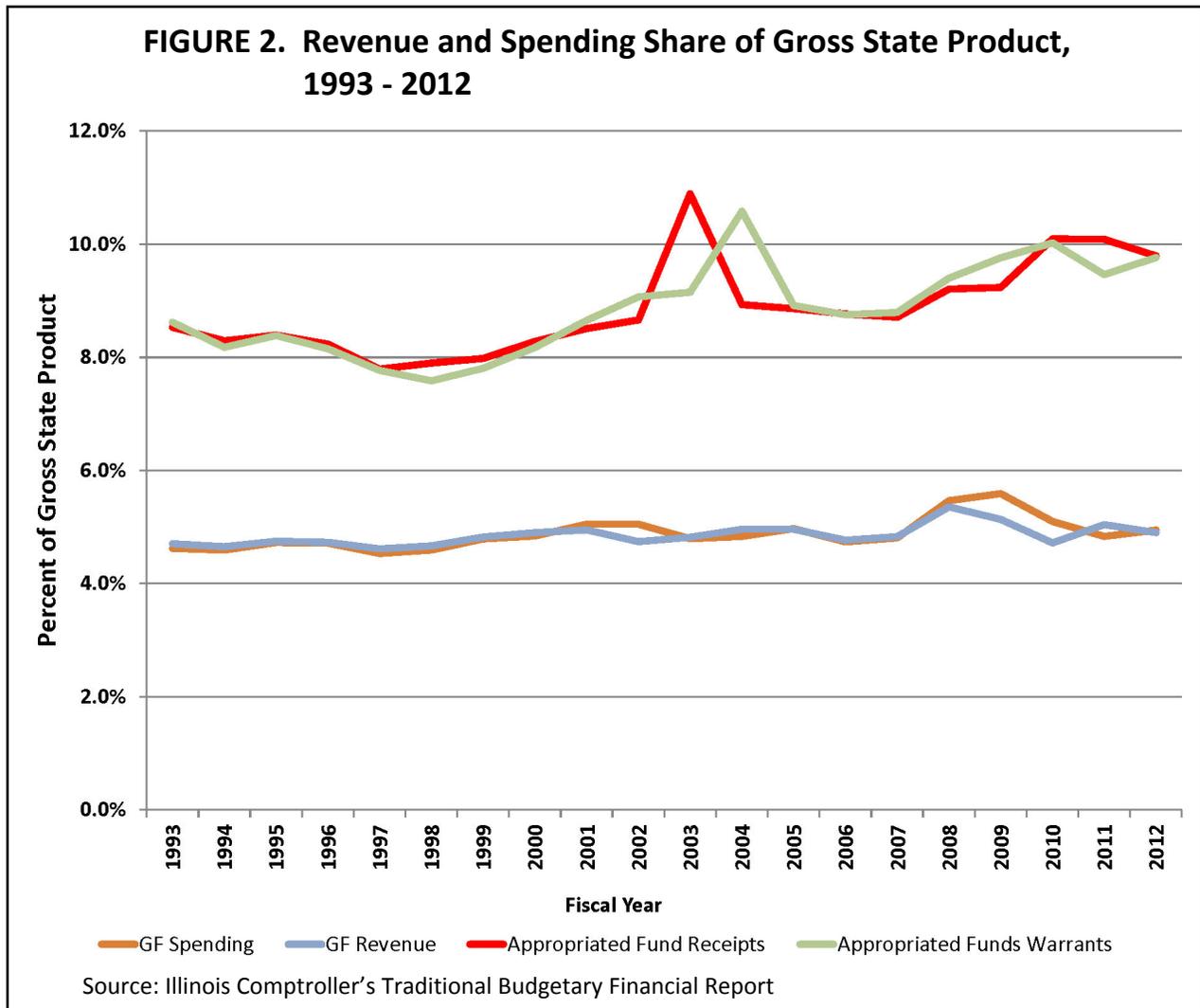
would have to say that Illinois taxes should be taking an ever greater share of the income earned by Illinois residents and the goods and services produced in Illinois.

Other states

While it is clear that Illinois revenues and spending grew faster than both inflation and the income of its residents during the same period, we should look at what is happening in other states. Turning to the Census Bureau’s Census of State and Local Government Finances, we can compare Illinois’ revenues and spending to that in other states and to the United States as a whole. The data is for general funds, is only available through 2011,

and excludes federal transfers so that revenues and spending are not comparable.

On the revenue side, states’ own source general revenues grew 128 percent from 1993 through 2011 (the latest data). Over the same period the comparable number for Illinois was 115 percent, so Illinois revenue growth trailed other states. Before the income tax rate increases, through FY 2010, Illinois trailed even further – with a 91 percent increase compared to a 113 percent increase in all other states. However, if the rate increases had been fully effective in FY2011, we estimate that Illinois would have grown 143 percent, above the 128 percent national average growth.



On the spending side, using the same Census data, Illinois general funds spending has more closely tracked that in other states. For all states during the 1993-2011 period general funds spending increased 185 percent; for Illinois the increase was 181 percent. (Note – spending growth exceeds revenue growth because revenues exclude transfers from federal government.) Bill Testa and Thom Walstrum, writing on the Federal Reserve Bank of Chicago’s blog observed that Illinois had kept its state taxes low and propped up spending through borrowing in a posting titled, “Will Efforts to Fix Illinois Budget Hamper Economic Growth?” April 11, 2013.

Illinois revenues grew more slowly than did revenues in other states during this period. Revenues growth lagged even more before the rate increases began to be seen in FY 2011, but would have exceeded revenue growth in other states had the tax rate hike been fully effective in FY 2011. Illinois spending growth more closely tracked spending in other states through FY 2011.

Unpaid bills

The comparison between revenues and spending ignores one important piece of the puzzle, Illinois’ growing pile of unpaid bills. When state government does not have enough money to cover its bills, it simply does not pay them and they do not show up in the comparisons.

Unpaid bills – in this case bills the comptroller was holding on the last day of the fiscal year because it lacked funds to pay them – rose from nothing at the end of 2007 to \$4.7 billion at the end of FY 2011. The figure had fallen to \$3.3 billion by June 30, 2013. These figures do not include bills that have not yet been submitted to the comptroller. The larger numbers for the backlogs include estimates of bills that have not yet been presented for payment.

Another view is the budgetary balance approach used by the Comptroller, premised on the notion that the state should end the year with enough money in the general funds to cover spending during the two-month lapse period. Under this approach the last time Illinois had a positive budgetary balance was FY2001. The budgetary balances below (all negative) plummeted when the Great Recession hit Illinois revenues, before recovering somewhat with the income tax rate increases in mid-FY2011.

- \$135 million in 2007,
- \$834 million in 2008,
- \$3,673 million in 2009,
- \$6,094 million in 2010,
- \$4,507 million in 2011,
- \$4,984 million in 2012, and
- \$3,988 million in 2013 (after the April surprise boosted revenues \$1.3 billion).

When spending demands outpaced revenues Illinois state government accumulated a backlog of overdue bills.

The Great Recession

In FY 2009 and 2010 the recession devastated income and sales tax collections. After growing by more than \$1 billion per year for four years, general funds revenues fell \$3.2 billion (17 percent) over the two fiscal years, 2009 and 2010. The revenue collapse was unprecedented. In the last 50 years Illinois never saw two consecutive years of general funds revenue declines, according to the Comptroller's records.

That is not to say there were not issues before the recession. One time revenues from fund sweeps and a tax amnesty program were used for current obligations, the refund fund was underfunded, and pension obligations were met with bonds, whose repayment reduces money available to spend today. For the best summary of this period see the *Illinois State Comptroller's Fiscal Focus*, "The State Fiscal Crisis – How Did We Get Here?" September 2011.

The Great Recession hit Illinois revenues hard – reducing tax receipts for two consecutive years, something that had never happened before. The hit came with the state already extended with spending supported from a series of one-time revenue increases.

Illinois' response to the Great Recession

In FY 2009 the fiscal hole was plugged with \$1.6 billion in federal stimulus funds and \$1 billion borrowed short term to speed up Medicaid payments as required by the federal stimulus legislation.

In FY 2010 the state issued \$3.5 billion in pension notes, moving the required current pension obligation out of the general funds.

In FY 2011 Illinois ran another tax amnesty that produced \$419 million in one-time revenues (and reduced future receipts), securitized (sold the future income stream from) the tobacco settlement for \$1.25 billion in one-time cash, and again borrowed to make its pension payment.

Finally in mid-year of FY 2011 Illinois increased its income tax. Since then there has been general shock that the increases did not solve Illinois' fiscal problems.

Illinois filled the holes created by the revenue hit with an assortment of one-time revenues.

How other states respond to the Great Recession

The National Association of State Budget Officers conducts a twice-a-year survey of how states are doing with their budgets – reviewing both revenues and expenditures. Their "Fiscal Survey of the States" from the fall of 2009 (after the 2009 budget year was completed and the 2010 budget enacted) reported that states had made \$31.3 billion in cuts to their enacted 2009 budgets. That included \$10.7 billion in California, \$2.3 billion in Georgia, \$2.0 billion in New Jersey and \$1.1 billion in both Ohio and South Carolina.

Illinois reported \$600 million in post 2009 budget-enactment cuts.

Note – Budget cuts don't always mean spending cuts. According to Illinois' Office of Management and budget, spending increased 10 percent for FY 2009 "despite efforts to control spending" because of union pay increases and pensions.

The same 2009 NASBO report indicated that on the revenue side for FY 2010, 29 states enacted tax and fee increases of \$24 billion. The largest were \$10 billion in California, \$1.1 billion in New Jersey, \$6.3 billion in New York, and \$1 billion in North Carolina.

Illinois enacted no revenue increases.

One year later (in the Fall of 2010) in the same NASBO report states identified \$18.3 billion in cuts to their enacted 2010 budgets, including \$1.9 billion in New Jersey, \$1.6 billion in Georgia, \$1.5 billion in Minnesota, and \$1.1 billion in Kentucky.

Illinois identified \$383 million in post enactment budget cuts.

On the revenue increase side of the fall of 2010 NASBO report, states enacted \$6.2 billion in revenue increases, including \$1.2 billion in California and more than \$900 million each in Arizona and New York.

Illinois did not enact any tax increases in 2010.

A year later, when Illinois Income Tax rate increases showed up in the next report states

were no longer enacting mid-year budget cuts and only Illinois, at \$3.1 billion, and Ohio, at \$400 million raised taxes.

In response to the "Great Recession," other states were quicker to make mid-year budget cuts and/or to increase taxes than was Illinois.

Conclusion

Some things are clear:

Since 1997 Illinois revenues have grown consistently in "real dollars" and are consuming an ever larger piece of the Illinois economy.

Illinois' spending outpaced its ability to pay for it, as evidence by the growing backlog of bills and soaring negative budgetary balance.

Other states reacted more quickly when hit by the Great Recession, by cutting spending or increasing taxes, or both.

No one should be shocked - given the extensive use of fiscal gimmicks that used one-time revenues to support ongoing expenses – that the significant income tax rate increases have not "solved" the fiscal issues.

Perhaps the lesson is that if budgeting has become so opaque that officials did not realize how deep a fiscal hole that Illinois had dug itself into, it is time to change the way Illinois approaches this vital process.

Taxable Property Values Decline for a Record Third Consecutive year

By Mike Klemens

Mike Klemens does tax policy research for the Taxpayers' Federation. He retired from the Department of Revenue in 2012.

The latest statewide property tax statistics compiled by the Illinois Department of Revenue illustrate the extent to which the local property tax base has been eroded by the real estate crash that began in 2008. The official figures show simultaneously: (1) erosion to the tax base, (2) increasing (although at a slower rate than previously) property tax collections, and (3) soaring property tax rates.

For 2012 taxes (payable in 2013) the total value of taxable property (the Equalized Assessed Value or EAV) in Illinois fell for the third consecutive year. Only twice in the last 35 years has Illinois seen even a one-year decline in taxable value (and one of those years came in 1979 when Illinois eliminated taxation of business personal property and replaced it with an income tax surcharge). Overall between 2009 and 2012 the value of taxable property in Illinois fell more than 18 percent, from \$393 billion to \$321 billion.

See Table 1.

The three-year decline was an abrupt reversal for local governments dependent upon property taxes, as it came on the heels of years of unprecedented increases in EAV,

during the real estate boom that preceded the bust. Taxing districts had been used to seeing annual statewide increases of \$1 billion plus in property tax receipts in the years before the real estate crash.

While taxing districts have seen a slowing of the increase in property tax receipts, property owners did not see a decline in their property tax bills. Homeowners, famously, saw the value of their homes decline at the same time that their property tax bills were going up. During the period that the property tax base declined 18 percent, total property taxes billed (“extended” is the property tax term) increased 6 percent.

Property tax billings increased at the same time that property values fell because property tax rates increased – an average of 30 percent in the 2009 to 2012 period. Property tax rates had been on a downward trend since the implementation of Tax Caps (formally the Property Tax Extension Limitation Law), but increased from an average of \$6.40 per \$100 of assessed value in 2009 to \$8.35 per \$100 in 2012.

As the real estate market begins to recover, all concerned are hoping for some stability: local governments for stable increases in tax

revenues and property owners for stability in the value of their property and tax bills.

Table 1. Illinois Statewide Equalized Assessed Valuations and Total Property Taxes Extended, 1991-2012				
Year	Equalized Assessed Valuation	Percent Change	Total Taxes Extended	Percent Change
2012	321,073,431,554	(7.76)	26,766,182,466	2.21
2011	348,071,849,473	(7.75)	26,187,486,829	1.05
2010	377,321,501,247	(3.97)	25,915,360,351	2.59
2009	392,939,664,165	1.53	25,260,324,314	1.99
2008	387,021,934,588	6.60	24,768,273,784	5.16
2007	363,068,281,744	9.58	23,551,888,622	4.94
2006	331,336,959,068	9.34	22,442,600,878	6.17
2005	303,038,485,640	9.05	21,139,352,308	5.99
2004	277,898,235,860	7.00	19,944,252,268	5.15
2003	259,727,001,224	7.86	18,967,874,308	5.92
2002	240,809,532,471	9.29	17,907,536,082	5.82
2001	220,330,253,329	7.91	16,922,710,220	5.98
2000	204,178,019,641	5.80	15,967,696,133	5.11
1999	192,993,890,240	5.62	15,191,472,335	3.79
1998	182,725,993,240	5.13	14,636,685,464	4.16
1997	173,812,593,140	5.06	14,051,445,772	4.17
1996	165,443,100,730	4.94	13,488,760,419	4.53
1995	157,653,736,563	5.00	12,904,653,583	4.61
1994	150,144,693,155	3.93	12,336,372,265	5.54
1993	144,468,536,120	5.75	11,688,433,768	5.46
1992	136,609,056,845	6.97	11,083,689,611	6.07
1991	127,707,027,322	8.65	10,449,484,587	8.08

Source: Property Tax Statistics, Illinois Department of Revenue

Taxpayers' Federation of Illinois

430 East Vine Street, Suite A
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