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Foster social and economic justice through advancing fact-based public policy solutions

Increasing the Income Tax Rate: One Method for Addressing Illinois' Long-term Fiscal Problems

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1. The Long-Term, Structural Shortcomings in Illinois' General Fund Are Driven by Flawed Tax Policy, Not Overspending on Services

1.1 The General Fund Deficit in Context of COVID-19

This past November, voters failed to ratify an amendment to the Illinois Constitution that would have permitted replacing the state's flat rate income tax with a graduated structure. That in turn killed the "Fair Tax" legislation, which was designed to raise around $3.6 billion in new, annual revenue (during a normal economy), by imposing higher income tax rates on the wealthiest three percent in Illinois, while reducing the income taxes paid by the bottom 97 percent of the state's earners.[1] This failure was unfortunate because the Fair Tax would have helped address key structural flaws in the state's tax policy that both drive its long-term General Fund deficits, and make Illinois one of the most regressive, and hence unfair, taxing states in the nation.[2]

As things stand today, the state's General Fund deficit is large and growing. Estimates are that the accumulated General Fund deficit will be around $8.3 billion by the end of FY 2021, the current fiscal year.[3] That means roughly 30 percent of the $28.1 billion in General Fund spending on services in FY 2021 will be deficit spending. It is also estimated that the General Fund deficit will in all likelihood exceed $13 billion by the end of FY 2022, which begins this upcoming July. So, if General Fund spending on services in FY 2022 is held to the exact same aggregate, nominal dollar level that is scheduled for FY 2021, 46 percent—or more—of FY 2022 spending on services could end up being deficit spending.[4] Those short-term deficits are significant, but they were artificially inflated by the temporary tax revenue shortfalls the state realized due to the economic decline caused by the pandemic.[5]

The good news is Illinois is slated to receive slightly over $7 billion in one-time, federal funding under the new state and local coronavirus relief funds being created by the Biden Administration.[6] This will offset a material portion of the COVID-19 related revenue problems Illinois is facing. Moreover, any remaining revenue challenges created by the pandemic will resolve themselves once the economy reverts to normal.

Which means the truly meaningful fiscal challenge confronting Illinois is not the two-to-three year revenue hit COVID-19 created, but rather the structural fiscal problems that continue to generate long-term, ongoing General Fund deficits, even during periods of normal economic growth. Indeed, according to the Comptroller's Office, Illinois has run a deficit in its General Fund every year for at least the last 18 consecutive years.[7] These incessant deficits are the real cause for concern, since over $9 out of every $10 of General Fund spending on services in Illinois goes to the four core areas of education, healthcare, human services, and public safety.[8]

1.2 Illinois' General Fund Deficits Are Not Caused by Over-Spending on Services

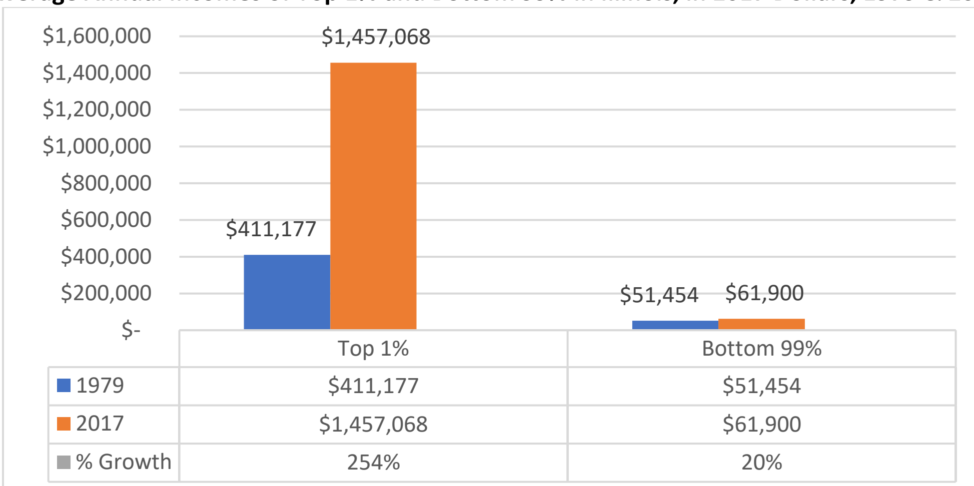
Given how essential the core services funded by state government are to communities across Illinois, it is crucial policy makers focus on addressing the true causes of the state's structural fiscal problems, so they can devise effective solutions thereto. Unfortunately, many elected officials and pundits continue to claim, erroneously, that overspending on services is primarily to blame for driving the state's General Fund deficits. The data, however, completely belie any such contention. In fact, , far from driving—or for that matter even contributing to—the growth in these deficits, overall General Fund spending on the four core services has been cut in real, inflation adjusted terms over the last two decades by around 20.6 percent, when compared to FY 2000 levels.[9]

1.3 Flawed Tax Policy and The Pension Ramp Are Driving the Structural Deficit in Illinois' General Fund

So how is it possible that Illinois continues to accrue ongoing General Fund deficits, given its long-term, real disinvestment in core services? Once again the data make the answer clear--Illinois' persistent General Fund deficits have two primary drivers: first and foremost is the structural deficit created by the state's flawed tax policy; and second is the worsening of that structural deficit caused by the state's unrealistic and unaffordable plan for repaying the debt it owes to its five public pension systems.

The starting point for Illinois' fiscal problems is the state's flawed tax policy, which is simply not designed to work in the modern economy. Key among these flaws is Illinois' utilization of a flat rate for its income tax. That is structurally unsound because it fails to respond to how incomes are distributed in the modern economy.[10] As shown in **Figure 1,** in Illinois (as well as nationally), most of the real growth in income that has occurred over the last 40 years has gone to the wealthiest**.**

Figure 1
Average Annual Incomes of Top 1% and Bottom 99% in Illinois, in 2017 Dollars, 1979 & 2017



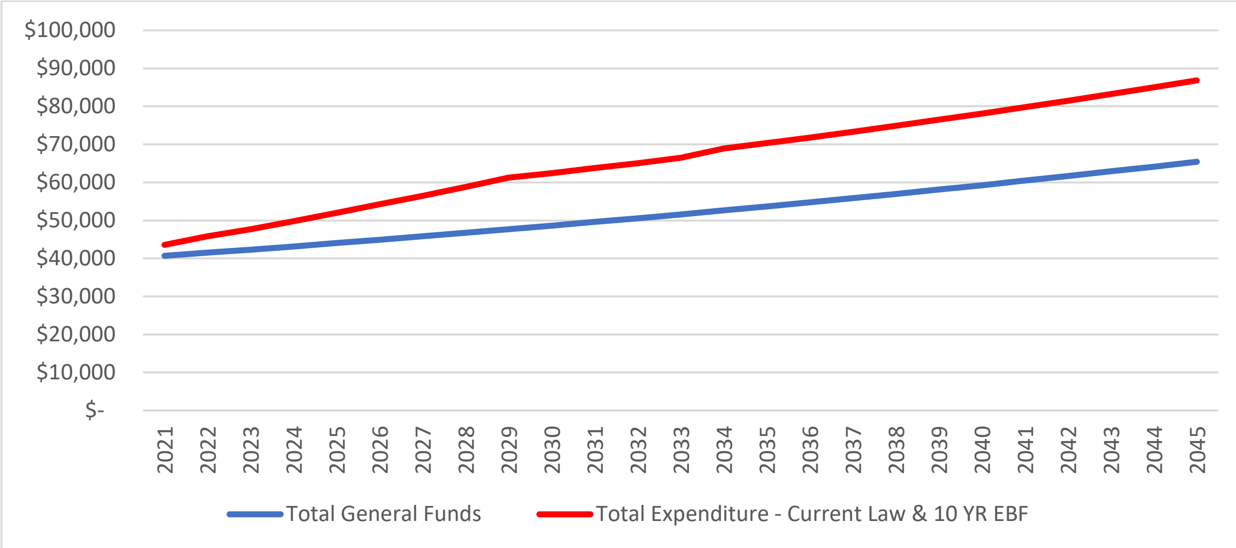
Source: CTBA analysis of IRS Statistics of Income for Illinois, 1979 & 2017, inflation-adjusted using CPI

A graduated rate income tax can be designed to respond to how income growth is actually distributed in the modern economy, by imposing higher tax rates on higher levels of income, and lower rates on lower levels of income. This not only creates some tax fairness by correlating tax burden with ability to pay, but also enables an income tax to generate adequate revenue growth over time, precisely because it focuses revenue generation where incomes are increasing most substantially. Illinois' flat-rate income tax, however, fails to create tax fairness because it ignores ability to pay, and likewise fails to generate revenue growth that keeps pace with the economy over time, because it fails to respond to how income growth is actually distributed in the economy over time.

Illinois' utilization of a flat-rate income tax, combined with other flaws in the state's mix of taxes and their respective structures,[11] have combined to create a fiscal system for the state that fails to generate annual revenue growth that is sufficient in amount to cover the cost of providing the same level of public services from one fiscal year into the next—even during a normal economy. This is known as a "**structural deficit**." The structural deficit that flawed tax policy has created in Illinois is so significant that, despite cutting real spending on services over the last two decades, the accumulated deficit in the state's General Fund never-the-less continued to increase over that sequence.[12]

Figure 2 shows how the structural deficit in the Illinois General Fund will grow over the next 25 years under current law, even if the state were starting with a balanced budget in FY 2021, rather than the accumulated deficit of $8.3 billion which it is actually projected to have.[13]

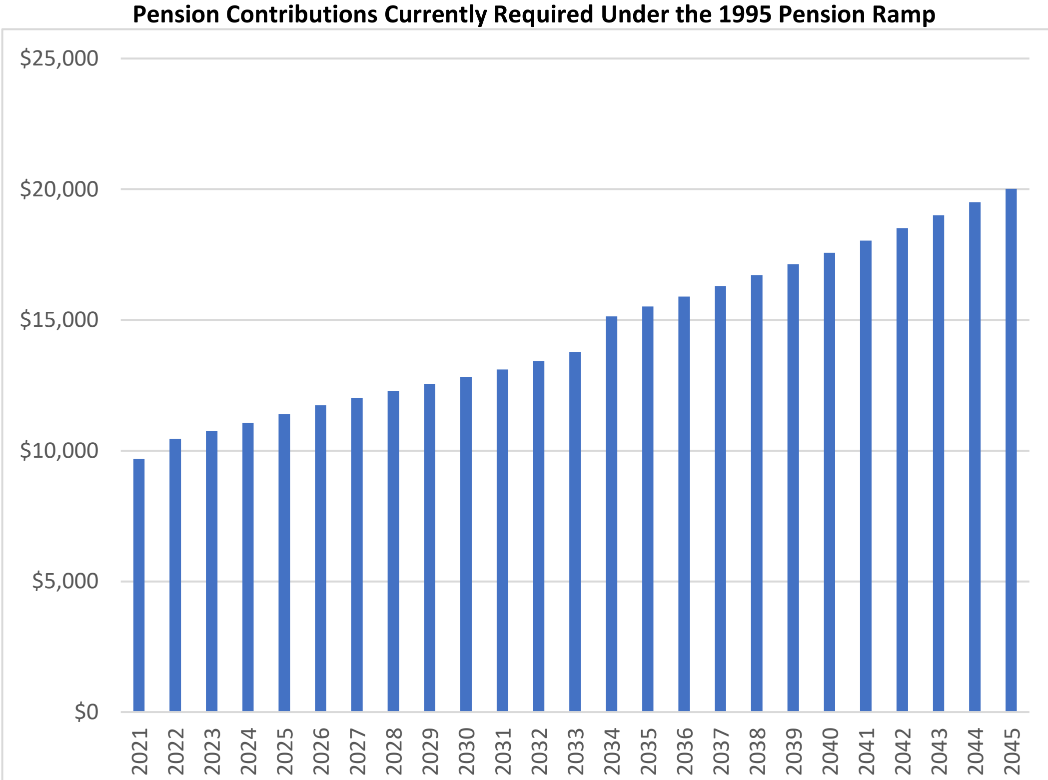
Figure 2
Projected Illinois General Fund Structural Deficit



Source: CTBA analysis of Illinois General Fund budgets, COGFA pension reports

Then there is the unaffordable, backloaded design of the schedule for repaying the "unfunded liabilities" (read that as "debt") the state owes to its five public pension systems, that was created under the "Pension Ramp" enacted in 1995.[14] The remaining repayment schedule under the Pension Ramp is shown in **Figure 3**.

Figure 3
Pension Contributions Currently Required Under the 1995 Pension Ramp



Source: Illinois State Retirement Systems Actuarial Valuation Reports

Illinois incurred this pension debt—which now stands at over $137 billion—in large part because politicians in both parties lacked the political will to raise the tax revenue needed to eliminate the structural deficit, and thereby fund services sustainably over time. Instead, they chose to maintain a portion of the General Fund spending on services that tax revenue growth was not covering due to the structural deficit, by engaging in the irresponsible practice of: (i) underfunding the actuarially required contributions owed to the state's pension systems; and then (ii) diverting the revenue that should have covered those pension contributions to instead fund delivery of current services, like education and public safety.

This was tantamount to the state using the pension systems like a credit card. Effectively, Illinois ran-up the balance of the debt it owed to its pension systems by intentionally underfunding annual pension contributions it was supposed to make, so it could use the revenue that such underfunding freed up to pay for current services. Of course, the state still had the constitutional obligation to repay the full balance of the unfunded contributions it was amassing overtime, with interest.[15]

From 1989 through 1995, decision makers were so aggressive in resorting to this irresponsible practice to maintain current service expenditures despite the structural deficit, that they managed to double the aggregate amount of unfunded liabilities owed to the pension systems.[16] So in 1995, Republican Governor Jim Edgar worked with elected General Assembly members in both parties to pass the "**Pension Ramp**," which was sold as a 50-year repayment plan that would ultimately get the state's five pension systems 90 percent funded by 2045.

However, rather than represent a departure from the irresponsible fiscal practices that necessitated its creation, the Pension Ramp—by design—made things worse. For starters, over the first 15 years the Pension Ramp was in place, it called for annual payments that were still significantly less than the actuarially required contributions. So instead of reducing the debt owed to the state's pension systems, the Pension Ramp actually continued to increase the unfunded liability—again, read that as "debt"—over this sequence by tens of billions of dollars.[17] Thereafter, as shown previously in **Figure 3**, the annual increases in debt service payments under the Pension Ramp were scheduled to increase at such unaffordable rates, that they exceeded both inflation, and what the state's flawed tax policy could possibly accommodate.[18]

The fiscal pressure created by the Pension Ramp is worsening the structural deficit in the state's General Fund. However, rather than raise taxes to cover the unrealistic back-loading of payments the Pension Ramp requires, this particular problem would be best resolved through a responsible re-amortization of that repayment schedule. To be responsible, any such re-amortization should be designed to: (i) replace the current backloaded repayment structure with a level dollar structure, so that taxpayer cost is held constant in nominal dollars over time, but actually declines in real terms annually after adjusting for inflation; and (ii) create an annual, level dollar payment amount that is sufficient to grow the funded ratio of the state's five pension systems every year, putting them on a path to fiscal health. For more information about how the Pension Ramp could be responsibly re-amortized in a way that saves taxpayers money, while bringing the pension systems to fiscal health, please see CTBA's report "Update: Addressing Illinois' Pension Debt Crisis With Re-amortization" (available online at ctbaonline.org/reports).

1.4 Increasing Tax Revenue Is the Responsible Way to Address the Structural Deficit in Illinois' General Fund

As things stand today, Illinois is suffering from a long-term structural deficit in its General Fund that cannot be eliminated without re-amortizing the Pension Ramp as detailed previously, and either raising taxes, or significantly reducing spending on core services like education, healthcare, public safety, and human services. The better public policy solution is to raise taxes, given that: (i) Illinois is already low spending on services per capita when compared to the rest of the nation[19](ii) Illinois has been cutting its real investment in core services for decades; (iii) underfunding core services is harming communities across the state; and (iv) flawed tax policy which resulted in poor revenue generation is the primary driver of the structural deficit in the General Fund to begin with.

There are two primary revenue sources that most states rely on to fund current services, the income tax and the sales tax.[20] Illinois is no exception, with roughly 54 percent of its General Fund revenue in FY 2020—the last complete fiscal year before COVID-19—coming from state level income taxes (individual and corporate, collectively) and another 22 percent coming from sales taxes.[21] Section 2 of this report highlights the amount of General Fund revenue that Illinois would realize from increasing its individual income tax rate.

Of course, because the state's constitution still requires that the individual income tax be levied at one, flat rate across all levels of income, any increase in Illinois' individual income tax would apply to all Illinoisans, irrespective of ability to pay.

If the goal is to raise revenue to help address the structural deficit, while also making tax burden incidence fairer, the amount of any such income tax increase that low- and moderate-income families would have to pay should be offset with targeted tax relief. One of the best ways to provide such tax relief is through the utilization of refundable income tax credits, as detailed in Section 3 of this Report.

2. Potential Revenue from Increasing the Flat Rate Income Tax in Illinois

There are 41 states in America with an income tax.[22] Illinois is one of only eight of those states that imposes its income tax at a flat rate. The reason for this is simple, the Illinois Constitution specifically provides that: "A tax on or measured by income shall be at a non-graduated rate."[23] Currently, the individual income tax rate in Illinois is 4.95 percent, while the corporate rate is seven percent.[24]

At this 4.95 percent rate, the individual income tax generated $20.8 billion in gross revenue for FY 2018.[25] However, as shown in **Figure 4**, not all of that revenue was available to cover General Fund expenditures. The reason for this is a portion of the state's gross income tax receipts each fiscal year are used to cover both: transfers into the "**Refund Fund**," which pays tax-filers' claims for income tax refunds in a given fiscal year;[26] and transfers into the "**Local Government Distributive Fund**" or "**LGDF**," through which the state shares a portion of its income tax receipts with local governments across Illinois.[27]

After those transfers were made, the net revenue from the income tax that went to the General Fund in FY 2019 was $17.7 billion.[28]

Figure 4
Fiscal Year 2018 Gross Income Tax and
Net Income Tax Revenue Available to General Fund

	Tax Year 2018 (in $ billions)
Gross Income Tax Revenue	$20.8
Refund Fund distribution (9.8% of Gross Income Tax Revenue)	$2.0
Local Government Distributive Fund distribution (6.06% of Gross Income Tax Revenue less Refund Fund)	$1.1
Net Income Tax Revenue for General Fund in FY2019	**$17.7**

Source: CTBA analysis of IDOR Tax Year 2018 Income Tax Revenue received via FOIA request; COGFA, "Illinois Tax Handbook for Legislators: March 2019."

If the Fair Tax initiative had passed, the new, graduated rate income tax structure it created would have generated around $3.6 billion in net new annual revenue for the General Fund.[29] **Figure 5** shows how much new income tax revenue would be generated annually in gross, and in net new revenue to the General Fund after accounting for the transfers to the Refund Fund and LGDF, if the existing 4.95 percent flat-rate income tax were to be increased by: one percentage point; 1.5 percentage points; 1.75 percentage points; and two percentage points.

Figure 5
New Annual Tax Revenue Generated From Increases to
Illinois' Current Flat Income Tax Rate for Individuals of 4.95 Percent

(in $ billions)	4.95%	1% increase (5.95%)	1.5% increase (6.45%)	1.75% increase (6.70%)	2% increase (6.95%)
Gross Income Tax Revenue	$20.8	$25.1	$27.2	$28.2	$29.3
Gross Revenue Increase over 4.95% Rate	-	$4.2	$6.3	$7.4	$8.4
Net Revenue Increase over 4.95% Rate	-	**$3.6**	$5.4	$6.2	$7.1

Source: CTBA analysis of IDOR Tax Year 2018 Income Tax Revenue received via FOIA request.

The good news is, increasing Illinois' flat rate income tax for individuals by one percentage point, from its current level of 4.95 percent to 5.95 percent, would generate around $3.6 billion in net, new revenue annually to help reduce the structural deficit in the state's General Fund—which is the same amount the Fair Tax would have generated. The bad news is, because Illinois has a flat rate for its income tax, everyone would see their income taxes increase, even low- and moderate-income earners. That's bad news, because Illinois already has one of the most unfair, regressive tax burdens of any state in America, when tax burden is measured as a percentage of income.[30]

In fact, as things stand today, the bottom 25 percent of income earners in Illinois have an in-state tax burden as a percentage of income which is almost twice that of the wealthiest, as shown in **Figure 6**.

Figure 6
Total State and Local Tax Burden in Illinois

Source: Institute on Taxation and Economic Policy

Given the disproportionally high tax burden low- and moderate-income families in Illinois already have under existing law, it does not make sense to increase their tax burden further. Especially considering their incomes have been flat or declining after inflation for the last 40 years.[31] However, Illinois can offset the additional tax burden that would be imposed on low- and moderate-income households when the state increases its flat rate tax income tax, by providing them with targeted tax relief through a refundable income tax credit.

3. Using Refundable Tax Credits to Create Tax Fairness in Illinois

A refundable tax credit is an effective way to design tax relief for two reasons. First, such credits typically identify the maximum amount a taxpayer can earn in a given year to qualify for the tax relief it provides. Hence these credits can be targeted precisely to the desired recipients. Of course, to retain its value over time, the income limits established in any refundable credit should be adjusted for inflation annually.

Second, making the credit "refundable," assures the desired recipients of the credit realize the full amount of tax relief the credit is intended to provide. The reason for this is simple, if the income tax liability of a taxpayer who qualifies for a refundable tax credit in a given year happens to be less than the dollar value of the credit, that taxpayer will receive a refund check from the state for the difference.

This refundability feature is a highly effective way to build tax fairness into a state fiscal system, because it allows for the offset of all state and local taxes that are being paid, not just the income tax. For proof, look no further than the Federal and Illinois-state level Earned Income Tax Credits ("**EITC**"), which have reduced tax burden for low- to lower-middle-income workers for decades, and have enjoyed broad bi-partisan support. Speaking of which, if Illinois were to simply double the dollar value of the existing EITC, it would provide a minimum of $460 million of new, aggregate tax relief to approximately 2.4 million working Illinoisans—or 37 percent of total taxpayers—with annual earnings up to about $22,000.[32]

Determining both the appropriate amount of tax relief to provide through a new refundable tax credit, as well as the maximum level of annual earnings an individual can have to qualify for claiming such credit in a given year, are difficult policy questions for the governor and General Assembly to resolve. However, the data make one thing very clear: the vast majority of low, middle and even upper middle income earners in Illinois have seen their annual incomes decline on an inflation-adjusted basis over the last 40 years.[33] So any new credit should be designed to offset some or all of the tax liability that most of these Illinois taxpayers would realize from an increase in the state's flat rate income tax.

As it turns out, according to the Illinois Department of Revenue ("**IDOR**"), most, as in 78 percent of all, Illinois taxpayers (including single taxpayers and married taxpayers filing jointly), had taxable incomes that were less than $75,000 in tax year 2018.[34] That equates to 4.9 million of the total 6.3 million individual tax returns filed in Illinois that year.[35] Hence, providing a new refundable income tax credit to taxpayers with less than $75,000 in annual, taxable income would effectively cover most of the state's taxpayers.

Designing such a credit requires that the following two key questions be answered:

First, what would it cost to implement a refundable tax credit that would offset the full amount of any additional income tax burden these 4.9 million taxpayers would incur when the state increases its flat rate income tax; and

Second, how much net new revenue would actually be available to reduce the structural deficit and cover General Fund services, after providing that tax relief, as well as covering the portion of new revenue raised to cover required for the Refund Fund and the LGDF?

Figure 7 shows both the cost of the new refundable credit, as well as the net new revenue that would go to the state's General Fund, if Illinois increased its flat individual income tax rate by one percentage point, going from its current level of 4.95 percent, up to 5.95 percent.

Figure 7

Gross and Net Revenue from an Increase of One percent to Illinois' Current 4.95 Percent Individual Income Tax Rate

(In $ millions)	4.95%	5.95%	Increase in Revenue
Gross Income Tax Revenue	**$20,846**	**$25,058**	**$4,211**
Refund Fund transfer out (9.8% of Gross Income Tax Revenue)	($2,042)	($2,456)	-
Local Government Distributive Fund transfer out (6.06% of Gross Income Tax Revenue less Refund Fund)	($1,139)	($1,370)	-
Net Income Tax Revenue for General Fund	**$17,664**	**$21,232**	**$3,568**
Potential Cost of Providing Income Tax Credit to taxpayers earning less than $75K	-	($1,147)	-
Net Income Tax Revenue for General Fund after Income Tax Credit	**$17,664**	**$20,086**	**$2,422**

Source: CTBA analysis of IDOR Tax Year 2018 Income Tax Revenue received via FOIA request; COGFA, "Illinois Tax Handbook for Legislators: March 2019."

Obviously, the General Fund would benefit from the infusion of $2.4 billion in new annual revenue this policy change would generate. Equally as obvious, however, is the fact that this initiative would raise significantly less—as in $1.2 billion less-- in new revenue for the General Fund annually than the Fair Tax initiative would have generated.

As shown in **Figure 8** to raise as much net new revenue to cover the General Fund services as would have been raised under the Fair Tax, and to offset the entire cost of the tax increase that would be borne by those 4.9 million Illinois taxpayers with taxable incomes below $75,000 annually, the flat rate income tax in Illinois would have to be increased by 1.5 percentage points, from its current level of 4.95 percent up to 6.45 percent.

Figure 8

Gross and Net Revenue from an Increase of 1.5 Percent to Illinois' Current 4.95% Individual Income Tax Rate

(In $ millions)	4.95%	6.45%	Increase in Revenue
Gross Income Tax Revenue	**$20,846**	**$27,163**	**$6,317**
Refund Fund transfer out (9.8% of Gross Income Tax Revenue)	($2,042)	($2,662)	-
Local Government Distributive Fund transfer out (6.06% of Gross Income Tax Revenue less Refund Fund)	($1,139)	($1,485)	-
Net Income Tax Revenue for General Fund	**$17,664**	**$23,016**	**$5,353**
Potential Cost of Providing Income Tax Credit to taxpayers earning less than $75K	-	($1,720)	-
Net Income Tax Revenue for General Fund after Income Tax Credit	**$17,664**	**$21,297**	**$3,633**

Source: CTBA analysis of IDOR Tax Year 2018 Income Tax Revenue received via FOIA request; FY2019 COGFA Tax Handbook

4. Using a Refundable Credit to Mirror the Fair Tax

As indicated previously, the Fair Tax had three main features: (i) it would have raised $3.6 billion in net new revenue for the Illinois General Fund; (ii) it would have raised all that revenue from the wealthiest three percent of taxpayers in Illinois; and (iii) it simultaneously would have reduced the income tax burden for the bottom 97 percent of taxpayers in the state. It would have accomplished all that by replacing the state's current flat income tax rate for individuals of 4.95 percent with the new, graduated rate structure shown in **Figure 9**.

Figure 9
Fair Tax Marginal Income Tax Rates

Marginal Rate	Taxable Income Bracket (Single)	Taxable Income Bracket (Joint)	Percent of Taxpayers
4.75%	$0-$10,000	$0-$10,000	27.2%
4.90%	$10,001 - $100,000	$10,001-$100,000	58.9%
4.95%	$100,001 - $250,000	$100,001-$250,000	11.1%
7.75%	$250,001 - $350,000	$250,001-$500,000	1.9%
7.85%	$350,000- $750,000	$500,001-$1,000,000	0.6%
7.99%*	$750,001 and over	$1,000,001 and over	0.3%

*Source: CTBA analysis of P.A. 101-0008 and IDOR Individual Income Tax return data; *Taxable income over $750K/$1M will be taxed at a flat rate of 7.99% and will not be subject to marginal rates*

Mirroring the outcomes that the Fair Tax would have generated with its graduated rate structure for the 97 percent of Illinois taxpayers with taxable earnings of $250,000 a year or less is difficult to do with a flat rate income tax, but not impossible. As shown in **Figure 10**, the state would have to increase its flat rate income tax for individuals to 12.5 percent, a bump of over seven full percentage points from its current level of 4.95 percent, to both: (i) generate a net of $3.6 billion in new revenue annually for the General Fund; and (ii) provide a distribution of refundable tax credits that would provide tax relief to the bottom 97 percent of earners in Illinois in a manner that would duplicate the lower, effective, marginal income tax rates they would have been subject to under the Fair Tax.

Figure 10
Using a Refundable Tax Credit and Illinois' Flat Rate Income Tax to Mirror the Fair Tax

(In $ millions)	4.95%	12.5%	Increase in Revenue
Gross Income Tax Revenue	**$20,846**	**$52,641**	**$31,796**
Refund Fund transfer out (9.8% of Gross Income Tax Revenue)	($2,042)	($5,159)	-
Local Government Distributive Fund transfer out (6.06% of Gross Income Tax Revenue less Refund Fund)	($1,139)	($2,877)	-
Net Income Tax Revenue for General Fund	**$17,664**	**$44,605**	**$23,759**
Potential Cost of Providing Income Tax Credit that mirrors Fair Tax Marginal Rates to taxpayers earning less than $250K	-	($20,143)	-
Net Income Tax Revenue for General Fund after Income Tax Credit	**$17,664**	**$21,297**	**$3,616**

Source: CTBA analysis of IDOR Tax Year 2018 Income Tax Revenue received via FOIA request; FY2019 COGFA Tax Handbook; : CTBA analysis of P.A. 101-0008

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Endnotes

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