JCUA FAIR TAX FAQ
9/03/2020

Why does Illinois have a Flat-Rate Income Tax?

Illinois did not have a state income tax prior to 1969. In 1969, Governor Richard Ogilvie, a Republican, signed legislation that established a flat-rate income tax system with rates of 2.5% for individuals and 4% for corporations. The legislation was viewed as a bipartisan compromise between the Governor (who had proposed higher tax rates) and Mayor Richard J. Daley. The new law was challenged in court but was upheld by the State Supreme Court.

At the State Constitutional Convention of 1970, delegates were divided over the question of a graduated income tax. Some proponents of graduated rates did not want to jeopardize voter approval of the new constitution over this issue. Ultimately, the convention decided that the new constitution should maintain the status quo, i.e., non-graduated rates and the 8-to-5 ratio between corporate and individual income taxes.

Key Takeaway: Since then, there has been greater acceptance of the idea of a state income tax, and a constitutional restriction adopted in 1970 does not necessarily make sense today. Only two other states have a constitutional requirement for a flat-rate income tax.

Background to Our Current Budget Situation: The Standoff

During the Great Recession that began in 2007-2008, state tax revenues plummeted across the U.S. Many states responded with a combination of spending cuts and tax increases. In Illinois, there were some spending cuts, but any kind of tax increase met with strong resistance in the General Assembly. The result was a large amount of deficit spending. By the end of FY 2009, the state had accumulated a $4 billion backlog of unpaid bills, which grew to $6 billion a year later (June 2010). With much bigger deficits projected for FY 2011, the General Assembly finally took action. In January 2011, the state instituted a temporary four-year increase in the individual income tax rate from 3.0% to 5.0%. The corporate income tax rate was raised from 4.8% to 7.0%.

During the last two years of Pat Quinn's tenure as Governor (2013-2014), there were several unsuccessful efforts to extend the higher tax rates. The backlog of unpaid bills, which had declined to $4 billion at the end of FY 2014, began to grow again. On January 1, 2015, the rates automatically declined to 3.75% for individual income taxes and 5.25% for corporate income taxes. Eleven days later, Governor Bruce Rauner took office.

The convergence of the drop in tax rates and the new Governor's policies triggered a prolonged budget impasse. Governor Rauner refused to raise income tax rates without pro-business policy changes that were blocked by the state legislature. This led to a failure to pass a complete budget. Without a full budget, the state continued to "function" through court orders, consent decrees, and existing statutory requirements. Public schools remained open due to full-year appropriations for elementary and secondary education. But other areas received partial or no funding during the impasse, including higher education, social services not covered by court orders, day-to-day agency operations, and state employee health insurance. A number of social service agencies were forced to close. For instance, the Chicago Coalition for the Homeless found that 90% of homeless service providers were forced to limit their intake of new clients, reduce services for current clients, lay off staff, eliminate programs, and/or close work sites. The Chicago Foundation for Women reported that due to limited funds going toward domestic violence shelters and prevention services, more than 3,600 adults and 4,200 children seeking shelter were turned away.

The impasse also did tremendous harm to the state's fiscal condition. By the end of FY 2017, the backlog of unpaid bills had grown to $9.3 billion. Moody's threatened to change the state's bond rating to junk bond level. This would have caused higher interest rates in borrowing.

After two years without a complete budget, the deadlock was broken in July 2017, when the General Assembly overrode the Governor's veto and raised the individual rate to 4.95%. Corporate rates were restored to 7.0%.

Several years after the standoff, the state still has a bill backlog of about $5.6 billion.

Key Takeaway: This episode, whose effects still resonate today, illustrated the dangers of improperly funding needed state initiatives. The state's bond rating, businesses, and particularly lower-income families suffered as a result of the impasse.

What is Progressive Taxation?

A progressive tax system is based the principle of ability-to-play; higher income groups pay a larger percentage of their *total income* than do lower income groups. In a *regressive* tax system, lower income groups pay a larger percentage of their *total income* than do higher income groups (e.g., sales taxes). In a strictly *proportional* tax system, all income groups would pay the same percentage of their total income.

Graduated income taxes are the most common tool for enhancing progressivity. But progressivity is a matter of degree. Among states with graduated tax rates, some have more progressive tax structures than others. Moreover, a flat-rate income tax can be made more progressive at the lower end of the income ladder through the use of standard deductions and personal exemptions (which lower the taxable income threshold) as well as targeted tax credits for low-income households.

JCUA FAIR TAX FAQ
9/03/2020

Key Takeaway: A progressive state tax system guards against lower-income groups paying a higher proportion of their income for taxes.

Broader Context of the Flat Tax in Illinois

The combined state-and-local tax system in Illinois is highly regressive. The individual income tax, which is mildly progressive at the lower end, accounts for only one-fourth of state-and-local revenue. Illinois does have a fairly generous earned income tax credit, which is targeted to low-income families with children. But the state offers no standard deduction and relatively small personal exemptions (about $2,000 per household member).

About two-thirds of combined revenue comes from regressive taxes — state and local sales taxes and local property taxes. According to a 2018 study conducted by the Institute on Taxation and Economic Policy, Illinois is the 8th most regressively taxed state in the nation. The poorest 20% of households pay 14.4% or their total income in state and local taxes, while the top 1% pay only 7.4%.

Key Takeaway: The combined state-and-local tax structure in Illinois places an unfair burden on low-andmiddle-income families. A graduated income tax would mitigate some of the regressive effects of other state and local taxes.

The Fair Tax Proposal amendment?

In May 2019, the General Assembly passed a joint resolution to amend the state constitution to allow enactment of a graduated income tax. In addition, the General Assembly passed and the Governor signed Senate Bill 687, which would institute a new graduated income tax structure. The statute will take effect at the beginning of 2021, but only if the constitutional amendment is approved by the voters.

Key Takeaway: The constitutional amendment that would eliminate the flat tax requirement is on the ballot for Nov. 3, 2020. It requires 60% of the votes on the ballot measure itself, or a simple majority of all those voting in the election. The new tax rates become effective IF the amendment initiative passes.

The Actual Amendment Change

ere is the actual ballot language:

"The proposed amendment grants the State authority to impose higher income tax rates on higher income levels, which is how the federal government and a majority of other states do it. The amendment would remove the portion of the Revenue Article of the Illinois Constitution that is sometimes referred to as the "flat tax," that requires all taxes on income to be at the same rate. The amendment does not itself change tax rates. It gives the State the ability to impose higher tax rates on those with higher income levels and lower tax rates on those with middle or lower income levels. You are asked to decide whether the proposed amendment should become a part of the Illinois Constitution."

Please note that the language itself does not use the term "Fair Tax". It also doesn't reference the tax rate changes passed in Senate Bill 687. The amendment would replace Article IX, Section 3 of the Illinois Constitution with the following language (note the cross-out):

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9/03/2020

SECTION 3. LIMITATIONS ON INCOME TAXATION

(a) The General Assembly shall provide by law for the rate or rates of any tax on or measured by income imposed by the State. ~~A tax on or measured by income shall be at a non-graduated rate. At any one time there may be no more than one such tax imposed by the State for State purposes on individuals and one such tax so imposed on corporations~~. In any such tax imposed upon corporations the highest rate shall not exceed the highest rate imposed on individuals by more than a ratio of 8 to 5.

If the constitutional amendment passes, Senate Bill 687 goes into effect with the following major provisions:

- Tax brackets and rates are summarized in the following chart:

Income Tax Brackets and Tax Rates in Senate Bill 687						
Joint filers				Single filers		
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Taxable income	Pct.			Taxable income	Pct.	
$10,000 or less	4.75			$10,000 or less	4.75	
$10,001-100,000	4.90			$10,001-100,000	4.90	
$100,001-250,000	4.95			$100,001-250,000	4.95	
$250,001-500,000	7.75			$250,001-350,000	7.75	
$500,001-1,000,000	7.85			$350,001-750,000	7.85	
Over $1,000,000	7.99	*		Over $750,000	7.99	*
* Rate applies to total taxable income.						

- The bill includes an increase in the property tax credit from 5% to 6% of taxes paid on a principal residence. (Joint filers with gross income over $500,000 and single filers with gross income over $250,000 are not eligible for the property tax credit.)
- A new child tax credit would provide $100 per child for low-income and moderate-income families. The tax credit would phase out for two-parent families with taxable income above $60,000 and single-parent families with taxable income above $40,000.
- Corporate income would still be taxed at a flat rate, which would increase to from 7% to 7.99%.

Key Takeaways:
- 97% of taxpayers would see a decrease in their state income taxes.
- The constitutional amendment does not create a "blank check" to raise taxes. The General Assembly already has the power to increase or reduce taxes. The amendment simply allows more flexibility regarding where the tax burden will fall.

Revenue Projections

Initial estimates from the Governor's Office of Management and Budget (GOMB) projected that the Fair Tax plan would generate $1.4 billion in additional revenue in FY 2021 and $3.5 billion in FY 2022. (The new tax rates would take effect in the middle of FY 2021.) However, the economic dislocation arising from the COVID-19 crisis will have a severe impact on state revenues. GOMB has estimated a revenue loss of $4.6 billion for the current fiscal year (FY 2021). Some kind of tax increase is imperative, and a graduated income tax can generate new revenue without increasing the burden on low- and middle-income households. In the long term, a graduated income tax can more effectively capture the benefits of economic growth, which have been heavily concentrated at the highest income levels over the past several decades.

How Would the Additional Revenue Be Used?

State spending is determined each year by the Governor's proposed budget and the appropriations process in the General Assembly. Much of the expenditure side of the state budget is mandated by federal or state law. Some of the new revenue generated by the Fair Tax could help reduce the state's backlog of unpaid bills, which stood at $5.7 billion at the end of FY 2020. Another high priority will be state aid to local school districts. In 2018, the State Board of Education implemented a new "evidence-based" funding formula designed to target more resources to school districts with the greatest need — i.e., districts with low levels of property tax wealth and districts with large concentrations of students from low-income families. The new funding system is being phased in gradually, and it requires an additional $350 million every year. Covid-19 and its impact on state revenue means that the new revenue is essential to prevent deep budget cuts in health care, human services, and education.

Other Arguments and Concerns

Wealthier individuals and businesses will flee the state.
The risk of "millionaire tax flight" is greatly exaggerated. A study by Stanford University sociologists and U.S. Treasury Department economists published in 2016 stated that the wealthy generally are "embedded elites" and not "transitory millionaires." The group concluded that "that millionaire tax flight is occurring, but only at the margins of statistical and socioeconomic significance".

Additional taxes will depress the business environment in Illinois and cause corporations to flee.
Taxation is only one factor that influences a company's decision to locate, and it's difficult to isolate tax rates as a factor in conducting studies. A 2019 study by Stanford University did show that some companies left after a 1% hike in the corporate state tax rate. Conversely, a Feb. 2019 report from the Center on Budget and Policy Priorities found that raising state income taxes on the wealthiest does not impede a state's ability to compete economically with its neighbors. In 6 of 8 states that had enacted higher taxes on the wealthy since 2000, "private sector economic growth met or exceeded that or neighboring states."

Most small businesses that file individual returns as partnerships or as "S corporations" will not be affected by passage of the Fair Tax. A large portion of these filers do not have any state income tax liability, and less than 10% have income above $250,000.

Shouldn't we solve the Illinois Pension crisis first before changing the tax structure?
This is a separate issue from the Fair Tax proposal, but it comes up often in discussion. There are five separate state-funded retirement systems. The three largest retirement systems cover public school

teachers outside Chicago, state government employees, and employees of public universities and community colleges.

The Illinois “pension crisis” refers to the gap between the benefits owed to participants in the state retirement systems and the amount of funding set aside by the state to make those future payments. At the end of FY 2020, the state’s long-term unfunded pension liability was estimated at $137 billion. The main reason for this problem has been inadequate funding for annual state contributions over several decades. State-funded pensions involve an extremely complicated set of fiscal, legal, and political issues, and there is no consensus on a solution.

Key Takeaway: A viable long-term solution to the pension situation needs to be found. But waiting for a solution to fund needed initiatives is not viable, particularly in the time of the COVID-19 pandemic.