

Improving Tax Fairness Through Income Tax Reform

By Lisa Christensen Gee

When adding up the effect of all state and local taxes, Illinois asks middle- and low-income households to pay a percentage of their income that is two to three times higher than the highest-income households pay.

It doesn't have to be this way. We can all pay our fair share to make sure Illinois has the money it needs for public resources we all value—including quality education, roads and bridges, and safe communities. Lawmakers can improve tax fairness in Illinois this legislative session by expanding the Earned Income Tax Credit (EITC) and reforming the state income tax to use a multi-tiered rate structure that applies lower rates to lower levels of income and higher rates to higher levels of income.

Illinois' Upside-down Tax System Disadvantages Middle- and Low-Income Households

In Illinois, low- and middle-income households pay a much larger percentage of their incomes in combined state and local taxes—property, sales, excise, and state income taxes—than do high-income households.

A household making \$10,000 a year, for example, pays 14 cents of every dollar in state and local taxes; a household making \$50,000 pays 11 cents for every dollar; and a household making \$1.5 million pays only 5 cents per dollar. This means that the household with

EXHIBIT 1

Illinois' Tax System is Upside Down

Total Share of Income Spent on State and Local Taxes by Non-Elderly Households



Source: Institute on Taxation & Economic Policy



\$10,000 pays almost *three times* as much as a share of their income in state and local taxes as the household making \$1.5 million, and the household making \$50,000 pays *more than twice as much* of their income as the household making \$1.5 million.

At a minimum, Illinoisans should all contribute the same share of their income to our shared priorities of quality education, public safety, and thriving local communities. An even stronger and fairer tax system, however, would reflect ability to pay, such that lower-income households pay a lower percentage of their income in taxes and higher-income households pay a higher percentage. Progressive tax systems like this make sense because higher-income households can afford to pay a larger portion of their income in state and local taxes and still have sufficient income to meet their basic needs, maintain a good quality of life, and save for the future.

Consider an example (Exhibit 2). An Illinois household of two adults and two children with \$50,000 in income currently spends 11 percent of their income on state and local taxes. After taxes (federal, state, and local) and covering the basic costs of living at a low-wage standard,¹ the household has only \$2,400 remaining to cover unexpected costs and save for

EXHIBIT 2

Fair Tax Systems Reflect Household Ability to Pay

Illinois Households	BUDGET 1 Current State and Local Tax System	BUDGET 2 State and Local Tax System Based on Ability to Pay
INCOME: \$50,000 	\$50,000 Total Income \$5,500 State & Local Taxes (10.9%) \$1,600 Federal Taxes \$40,500 Basic cost of living <hr/> \$2,400 Remaining income	\$50,000 Total Income \$3,000 State & Local Taxes (6%) \$1,600 Federal Taxes \$40,500 Basic cost of living <hr/> \$4,900
INCOME: \$274,000 	\$274,000 Total Income \$20,800 State & Local Taxes (7.6%) \$71,100 Federal Taxes \$40,500 Basic cost of living <hr/> \$141,600 Remaining income	\$274,000 Total Income \$23,300 State & Local Taxes (8.5%) \$71,100 Federal Taxes [†] \$40,500 Basic cost of living <hr/> \$139,100
Revenue Collected by Illinois State & Local Governments	\$5,500 Household #1 \$20,800 Household #2 <hr/> \$26,300 Total	\$3,000 Household #1 \$23,300 Household #2 <hr/> \$26,300 Total

[†]Simplifying assumption: estimate does not reflect change in federal offset for itemizing deductions.

¹The average statewide pre-tax cost of living for low-wage families with two adults and two children is \$40,500. This estimate includes costs of food, housing, medical care, child care, transportation, and other necessities. Source: Amy K. Glasmeier, Living Wage Calculator, online at <http://livingwage.mit.edu/states/17>.

the future. The household with \$274,000 pays only 7.6 percent in taxes and has \$141,600 remaining. If the state and local effective tax rates for these households were alternatively 6 and 8.5 percent, state and local governments could raise the same amount of money to pay for critical public priorities while leaving the lower-income household much better able to meet its present and future needs.

Unlike this example, Illinois' tax system is not based on ability to pay. In fact, it is quite the opposite. Illinois' tax system is *regressive*, meaning middle- and low-income households pay a larger percentage of their incomes in state and local taxes than do higher-income households. Said more plainly, those who can afford the least are contributing a bigger chunk of their income for the services we all depend on.

Why Is It Upside Down? The Sources of Unfairness in Illinois' Tax System

Illinois has one of the most upside-down tax systems in the nation.² This is due to our reliance on the kinds of taxes that eat up so much of what middle- and low-income households earn—including property, sales, and excise taxes—and our failure to offset the upside-down effects of these taxes through a highly progressive income tax.

Why do property, sales, and excises taxes eat up more of the income from middle- and low-income families than high-income families? Consider sales and excise taxes as an example. Sales and excise taxes require all households to pay the same rate regardless of their level of income. Buying 10 gallons of gas at a local station? A household with \$25,000 and a household with \$130,000 will both pay \$9.43 in sales and excise taxes.³ This may seem fair on its face, but what you don't see is the drastically different consequences these taxes have on each household once they are all added up.

The household with \$25,000 spends approximately \$12,100 a year on taxable goods and the household with \$130,000 spends approximately \$33,600.⁴ If both households pay an 8 percent tax on these purchases, the household making \$25,000 will pay about \$970 in sales and excise taxes and the household making \$130,000 will pay about \$2,700.

Although the higher-income household buys more taxable goods and pays a higher total amount in sales and excise taxes, because it has significantly more income than the household with \$25,000, the sales and excise taxes it pays account for only 2.1 percent of total income. On the other hand, the household with \$25,000 pays 3.8 percent of their income in sales and excise taxes. This is the effect of applying a single rate to all households regardless of ability to pay—sales and excise taxes require a larger share of income from the lower-income family than the higher-income family. Property taxes in Illinois have a similar effect.

² Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," 4th ed. (2013).

³ Tax estimate includes a \$0.19 /gallon non-diesel motor fuel tax and an average local sales tax of 7.35 percent.

⁴ FPC calculations based on data from Table 2 of the Consumer Expenditure Survey, 2011.

While sales, excise, and property taxes are important sources of revenue for funding public priorities, when paired with a flat income tax like Illinois currently has, Illinoisans are left with an upside-down tax system that asks too much of middle- and low-income households. However, if Illinois improved its income tax such that those with higher incomes pay a higher share of their income and those with lower incomes pay a lower share, Illinois could improve the fairness of its overall tax system.

Improving Fairness: A New Income Tax Rate Structure and Expanding the EITC

Lawmakers are currently considering two reforms that would vastly improve tax fairness in Illinois: 1) replacing the current flat rate income tax structure with a multi-tiered structure that applies lower rates to lower levels of income and higher rates to higher levels of income; and 2) expanding the state Earned Income Tax Credit (EITC).

Adopt a Multi-Tiered Income Tax Rate Structure

Illinois could improve the fairness of its overall tax system by substituting its single-rate structure for a multi-tiered rate structure that applies lower rates to lower levels of income and higher rates to higher levels of income.⁵

For example, the following rate structure has been suggested by Senator Don Harmon:

- the first \$12,500 of taxable income would be taxed at 2.9 percent;
- income between \$12,500 and \$180,000 would be taxed at 4.9 percent; and
- income earned above \$180,000 would be taxed at 6.9 percent.

Under this rate structure, households with income under roughly \$200,000 would actually see their income taxes *decrease*.⁶ Households with income above around \$200,000 would see their income taxes go up, but modestly relative to their income. In addition, middle- and low-income households would see the total share of their income spent on all state and local taxes go down, while higher-income households would see that share go up, making Illinois' state and local tax system fairer.

Adopting such a structure requires a change to the state's constitution, which currently mandates a one-rate income tax. Lawmakers should pass legislation to give voters the opportunity to choose a more fair system this November by amending the constitution to allow for an income tax that is based on ability to pay.

⁵ This is known as a graduated rate structure.

⁶ Although a household making \$200,000 is in the top income bracket under this proposed structure, they would experience an overall tax reduction because their first \$180,000 of income is subject to lower rates than they pay now. Under the current system, every dollar of taxable income is taxed at a rate of 5 percent, meaning a household with \$200,000 in taxable income pays \$10,000 in taxes. Under the multi-tiered structure, the first \$12,500 of taxable income is taxed at a rate of 2.9 percent, equaling \$362.50; the next \$167,500 is taxed at a rate of 4.9 percent, equaling \$8,207.50; and the remaining \$20,000 is taxed at a rate of 6.9 percent, equaling \$1,380. In total, the household pays \$9,950 in taxes under this multi-tiered structure, which is \$50 less than what it would pay under the current income tax.

Expand the Earned Income Tax Credit (EITC)

Lawmakers can also make our tax system fairer by expanding the state's Earned Income Tax Credit (EITC)—a reform that has been both proposed by Governor Quinn and introduced in legislation.

The state EITC only goes to households that work at low wage jobs and it primarily benefits families with children. It reduces state and local taxes paid by working families, allowing them to keep more of what they earn to pay for basic needs. And these families put the money right back into their local economies as they spend it at Illinois local businesses.

Right now the Illinois EITC is modest in its value, currently set at 10 percent of the federal Earned Income Tax Credit.⁷ By doubling the value, as has been proposed, the state EITC would go a lot further in reducing the substantial state and local taxes low- and moderate-income households in Illinois pay, while helping these families better provide for their basic necessities.

In addition to increasing tax fairness, recent research also suggests that the EITC expansion could impact child outcomes well beyond the time in which their families claim the credit—including better academic performance, higher likely of college attendance, and higher earnings as adults.⁸

Conclusion

It is important that our state and local governments are able to raise sufficient money to pay for important public resources including education, roads and bridges, and public safety. However, Illinois can and should raise this money in a manner that takes less of a toll on middle- and low-income households. By putting in place a multi-tiered income tax based on ability to pay and expanding the state's Earned Income Tax Credit, Illinois can make significant steps towards improved tax fairness.

⁷ There are 26 states (including the District of Columbia) that have created earned income tax credits. Ten of these states have credits equal to at least 20 percent of the federal EITC. Examples include Delaware (20%), Minnesota (25-45%), New York (30%), and District of Columbia (40%). Source: <http://www.taxcreditsforworkingfamilies.org/earned-income-tax-credit/states-with-eitcs/>.

⁸ Greg J. Duncan, Pamela A. Morris, and Chris Rodrigues, "Does Money Really Matter? Estimating Impacts of Family Income on Young Children's Achievement with Data from Random-Assignment Experiments," *Developmental Psychology* (June 2011), pp. 1263–1279; Raj Chetty, John N. Friedman, and Jonah Rockoff, "New Evidence on the Long-Term Impacts of Tax Credits," Statistics of Income Paper Series, November 2011, <http://www.irs.gov/pub/irs-soi/11rpchettyfriedmanrockoff.pdf>.

ABOUT THE FISCAL POLICY CENTER

The Fiscal Policy Center at Voices for Illinois Children provides timely, credible, and accessible information and analysis on fiscal issues that affect children, families, and communities in Illinois. The FPC is a member of the State Fiscal Analysis Initiative (SFAI), a network of nonprofit organizations in more than 40 states. SFAI is coordinated by the Center on Budget and Policy Priorities, a Washington, D.C.-based research organization and strategic policy institute that works on a range of federal and state issues.

The Fiscal Policy Center is funded by the Annie E. Casey Foundation, the Center on Budget and Policy Priorities, the Chicago Community Trust, and the Ford Foundation. We thank our funders for their support but acknowledge that the findings and conclusions presented in this report do not necessarily reflect the views of these organizations.

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