



# FISCAL FACT

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## Illinois Should Respond to Recession by Broadening Tax Bases and Spending Frugally, Not by Raising the Personal Income Tax Rate

*By Justin Higginbottom*

### Introduction

Though it isn't exactly breaking news to Illinoisans, their state government is in horrible fiscal shape. The recession left a budget shortfall of around \$11 billion for the combined fiscal years 2009 and 2010. Their 2010 budget borrowed a few billion, shoved a few billion onto next year's docket, and still left the state with a shortfall of over \$4 billion.

Illinois is on borrowed time. And although taxes alone should not be relied on to bring the state out of the red, a change in tax policy can help its economy. The state should expand tax bases to end government distortions in the economy and enable the enactment of lower statutory tax rates.

Tax hikes that risk making an already harsh tax climate for business more so should be avoided. Hiking personal income taxes especially, as proposed by Gov. Quinn, would mar one of the only good features of Illinois's tax system, making the state certainly less attractive to the businesses and individuals that Illinois ought to be courting.

### Overview of Illinois's Tax Climate

When state officials think of how their states can compete to be the location where new businesses start and existing businesses expand, they usually approach the task with an elaborate public relations campaign and payoffs to targeted companies in the form of special tax abatements, credits and other red-carpet treatment. Alas, this strategy is a disastrous misconception of economic development. If states have reasonable tax laws, they will not need to promise embarrassingly generous credits to incoming firms, and the tax comparisons that we cite here are

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all based on the concept that most of the competition is over after the statutory tax rates have been set by the legislature.

### *State Business Tax Climate Index*

Illinois's tax climate makes it an unattractive place for business, compared with much of the country. It ranks 30 out of 50 in the Tax Foundation's 2010 State Business Tax Climate Index (where 1 is the best); a measure of each state's "tax-friendliness" toward business. The top states are those with economically neutral and simple tax systems. Illinois's score is worse than three neighbors while the other two bordering states have scores in the bottom ten (see Table 1).

### *State-Local Tax Burden*

Another big-picture evaluation of Illinois's tax system is the Tax Foundation's annual calculation of how heavy the state-local tax burden is for the population in each state. With "tax burden" defined as the percentage of total state income taken in taxes, Illinois taxpayers were not unduly burdened during fiscal year 2008. That year, the national average burden was 9.7 percent of income. Illinois residents paid 9.3 percent, less than the residents of 29 other states. The residents of Illinois's neighboring states have similar burdens—except Wisconsin where residents face the 9<sup>th</sup> highest burden in the country.

### *Property Taxes*

Property taxes on owner-occupied homes are quite high in Illinois, 6<sup>th</sup> highest in the country as a percentage of median home value. That is higher than in all its neighboring states except Wisconsin. Counting commercial real estate and other property, as well as owner-occupied homes, Illinois still has heavily taxed property, but the ranking falls a bit. State and local tax collections in 2007 totaled \$1,605 per capita, 9<sup>th</sup> highest nationwide.

### *Sales Taxes*

The average sales tax rate in Illinois is a comparatively high 8.4%. That includes the state rate of 6.25%, plus a weighted average of all local rates, 2.15%. Of course, that means the total rate is higher in some locations, such as in Chicago where the state, county and city taxes total 10%. Illinois sales tax rates are higher than in any of its neighboring states, and nationwide, only five states have a higher combined state-local rate: Louisiana, Oklahoma, California, Tennessee, and Washington.

### *Income Taxes*

Illinois's corporate income tax of 7.3% (the state corporate income tax of 4.8% plus the personal property replacement tax of 2.5%) is comparatively high nationwide, but three of Illinois's neighbors have even higher rates. Two neighboring states have lower rates.

The best feature of Illinois's tax system is its personal income tax—a flat 3% (the lowest flat rate in the country). A flat rate with few deductions and credits stabilizes revenue flows from year to year, and it helps minimize the extent to which individuals and non-corporate businesses make economic decisions because of taxes instead of economic fundamentals. A low personal income tax rate keeps Illinois competitive and is less burdensome for people in the state.

**Table1**  
**Various Measures of Illinois’s Tax System Compared to Neighboring States**  
 Statutory Rates as of March 2010

State	2008 State-Local Tax Burden: Percentage of State Income and Rank (1 is highest)	Rank in 2010 State Business Tax Climate Index (1 is best)	Top Income Tax Rate*	Top Corp. Income Tax Rate*	Property Taxes on Owner-Occupied Housing as Percentage of Median Home Value and Rank (2008)	State-Local Combined Sales Tax Rate**
Illinois	(9.3%) 30	30	3%	7.3%	(1.57%) 6	8.4%
Indiana	(9.4%) 28	12	3.4%	8.5%	(0.96%) 21	7%
Iowa	(9.3%) 31	46	8.98%	12% <sup>†</sup>	(1.24%) 15	6.94%
Kentucky	(9.4%) 25	20	6%	6%	(0.7%) 32	6%
Missouri	(9.2%) 32	16	6%	6.25%	(0.87%) 23	7.18%
Wisconsin	(10.2%) 9	42	7.75%	7.9%	(1.71%) 4	5.42%

\* Highest bracket rate  
 \*\* Includes a weighted average of all local rates.  
 † Federal deductibility applies.  
 Source: 2010 Facts and Figures: How Does Your State Compare? Tax Foundation, 2010.

## Changes in Tax Policy Illinois Should Consider

### *Expand Illinois’s Tax Base*

In 2008 Illinois had over \$6.6 billion in foregone revenue from over 200 tax and fee breaks.<sup>1</sup> While some “tax expenditures” can be justified, others are used to steer industry or benefit a select group. By ending distortionary and targeted tax breaks, effectively extending the tax base, Illinois can chip away at its high tax rates, especially in the sales tax and corporate income tax. The goal of Illinois tax policy should be to move towards broad bases and low rates.

### *Expand Sales Tax Base*

The Illinois comptroller estimated that in 2008 the state had forgone over \$1.4 billion in tax revenue by exempting groceries, drugs, and medical appliances from the state sales tax. Expanding the sales tax base to include these items would end politically motivated price distortions, provide a less volatile sales tax base, and with the extra revenue enable the state to lower rates generally for the sales tax or elsewhere.

Exemptions for groceries and medicine are popular and have been enacted in many states during the past decade, but they are unwise tax provisions. The principal reasoning is that the poor spend a larger share of their income on these items, but Illinois already has a food stamp program that provides not only tax-free groceries but totally free groceries. If the state wishes to further subsidize groceries or medicine for those few citizens who can not afford a moderate sales tax, they should do it in the least distortionary way possible. That might mean expanding the food stamp program instead of granting a blanket exemption on roughly one-fifth of consumer purchases.

<sup>1</sup> [http://www.apps.ioc.state.il.us/ioc-pdf/2008\\_Tax\\_Expenditure\\_Report.pdf](http://www.apps.ioc.state.il.us/ioc-pdf/2008_Tax_Expenditure_Report.pdf)

Another base-broadening measure would be to apply the sales tax to services—such as hair styling, tattoo services, etc. A 2008 estimate reports that Illinois could collect \$3.6 billion in extra revenue by taxing services (excluding business-to-business services).<sup>2</sup>

### *End Business Incentives<sup>3</sup>*

Politicians should not try to pick industry winners and losers using tax policy. If they were good stock pickers, they'd be making good money doing that. Yet it's standard operating procedure for public officials with little knowledge of the market to bet their taxpayers' money on targeted industries that appear for the moment to be "the next wave" or "the best way to create jobs" or some such public relations drivel. Targeted business tax breaks should be repealed—and the corporate income tax base expanded—so that the tax rate on all business in general can be decreased. What follows are a few of the obvious types of programs that should be ended, though there are sure to be more.

Illinois should stop courting movie stars by enacting generous film production services credits. Those cost the state nearly \$10 million in forgone revenue in 2008 and produced an unknown benefit of temporary jobs that proponents puff up into absurd estimates of increased economic activity.<sup>4</sup>

The state's "Economic Development for a Growing Economy Tax Credit Program" offers tax incentives for companies willing to locate or expand in Illinois when there is "active consideration of a competing location in another State."<sup>5</sup> But putting the words "growing economy" in the title does not make the credit work. In 2008 it cost Illinois \$23.5 million. To attract and keep businesses Illinois should drop corporate income rates. Getting rid of credits like this can make it possible.

The bio-fuel industry has got it especially good in Illinois. Twenty percent of the sale of gasohol, a blend of gasoline and ethanol, is exempt from state sales tax, losing the state \$133 million in 2008. Up to 100 percent of biodiesel proceeds can be exempt from sales tax, accounting for an additional loss of \$111 million in 2008.

The research and development income tax credit for businesses that increase research activities cost the state \$29 million in 2008. But the public benefit of businesses engaging in research to earn a profit is merely anecdotal. Instead of favoring research-heavy industries, Illinois should again make its tax climate good for all business.

### *Caution for Income Tax Increases*

Governor Pat Quinn supports a personal income tax increase to help close Illinois's budget deficit. But raising the personal income tax rate by 1 percentage point from 3 percent to 4 percent (a 33% increase in the rate) would drop Illinois four spots, to 33<sup>rd</sup>, on the tax Foundation's Tax Climate Index, and Illinois would no longer have the lowest personal income tax in the region (Indiana's income tax rate is 3.4%), giving up Illinois's only such advantage.

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<sup>2</sup> <http://www.ilga.gov/commission/cgfa2006/Upload/2009-JULY%20SERVICE%20TAXES%20Update%20REPORT.pdf>

<sup>3</sup> The numbers cited here come from a 2008 study. The revenue raised by ending these incentives will be different dependent on the current state of the economy.

<sup>4</sup> See Tax Foundation Study: "Movie Production Incentives: Blockbuster Support for Lackluster Policy," <http://www.taxfoundation.org/files/sr173.pdf>.

<sup>5</sup> [http://www.commerce.state.il.us/dceo/Bureaus/Business\\_Development/Tax+Assistance/EDGE.htm](http://www.commerce.state.il.us/dceo/Bureaus/Business_Development/Tax+Assistance/EDGE.htm)

Corporate income tax increases similarly should not be used to cure the budget. Revenue from corporate net wealth is known to be volatile—especially during a recession—and it would be unwise for a state to lean heavily on it. In the third quarter of 2009 personal income tax revenue from all states dropped 11.8%, sales tax revenue decreased by 8.9%, and corporate income dropped the farthest by 22.6%.<sup>6</sup> In Illinois, corporate income tax revenue dropped a staggering 27.6% in that quarter, as income tax revenue and sales tax revenue dropped 11.8% and 11.6% respectively. (Illinois was likely saved from a larger drop in personal income tax because of its flat rate.) Raising the corporate income tax might set the state up for an even bigger fall in the future.

Illinois should try to attract people and (all) business to the state. Over the past 15 years more taxpayers on net have been leaving the state than moving in—for many reasons.<sup>7</sup> But raising income taxes certainly could not help this trend.

## Conclusion

Illinois's fiscal problems should not be solved by taxes alone. The state had over \$54.4 billion in unfunded pension liabilities in 2008 and \$39 billion in unfunded health care and other benefits in 2007.<sup>8</sup> State spending increased 39 percent from 1998 to 2008, after inflation, far outpacing population growth.<sup>9</sup>

Illinois needs to make politically difficult spending choices and not rely on “easy” income tax increases. The state should expand its sales and business tax base: include services and end exemptions for the sales tax, and throw out business incentives. With this extra revenue the state can work on its high property, sales, and corporate income tax rates, making the state attractive to business and residents and creating a stable revenue base for the future.

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<sup>6</sup> [http://www.rockinst.org/pdf/government\\_finance/state\\_revenue\\_report/2010-01-07-SRR\\_78.pdf](http://www.rockinst.org/pdf/government_finance/state_revenue_report/2010-01-07-SRR_78.pdf)

<sup>7</sup> Internal Revenue Service

<sup>8</sup> [http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Initiatives/R\\_and\\_D/Trillion\\_Dollar\\_Gap\\_factsheets\\_Illinois.pdf](http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Initiatives/R_and_D/Trillion_Dollar_Gap_factsheets_Illinois.pdf)

<sup>9</sup> [http://www.illinoispolicy.org/uploads/files/growthinstatespending\\_pp-1.pdf](http://www.illinoispolicy.org/uploads/files/growthinstatespending_pp-1.pdf)