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# MAKING ILLINOIS TAXES MORE FAMILY FRIENDLY

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With the federal budget projected to run surpluses adding up to more than $5 trillion over the next 10 years, there has been much talk of cutting taxes but little agreement on how. One possibility that could gain bipartisan support is a proposal in the report *Giving Tax Credit Where Credit Is Due* (Cherry and Sawicky 2000), which outlines a way to merge and expand the Earned Income Tax Credit (EITC), the dependent exemption, the Child Tax Credit, and the Additional Child Credit. The result would be a single credit for working families with children called the Simplified Family Credit (SFC).

The SFC concept could be pursued by both national and state governments. Such a reform would simplify tax systems; improve work incentives; reduce marriage penalties; help poor families distance themselves from the poverty line; provide middle-class tax relief; and boost the economies of local jurisdictions with a large number of middle- and lower-income workers.

Legislation for the SFC is pending in the U.S. Congress. Its political appeal stems, in part, from the fact that it provides greater benefits to many middle-class families than does the Bush Administration's proposal, and at much lower cost. It also simplifies the tax code, something the Bush Administration proposal does not purport to do at all.

## Economic inequality in the U.S. and in Illinois

Currently, the U.S. economy appears to be in the twilight of a remarkable growth spurt. Although unemployment remains at historically low levels, several key economic indicators suggest that a downturn has begun for the U.S. economy.

While overall economic performance has been exemplary, the prosperity has been unevenly shared, with some groups even experiencing declines in income. In Illinois, the bottom 20% of families actually averaged a small decline in annual, inflation-adjusted income between 1980 and 1998 (Bernstein et al. 2000). At the same time, the top 5% of families in Illinois enjoyed an average 42% (or $69,000) increase in their income. These disparities in Illinois were reflective of the nation as a whole: the bottom fifth of U.S. families averaged a 6.5%

decrease in income, while the top fifth saw an increase of 33%. The top 5% of U.S. families did even better, with an average increase of 56%.

One positive development, though, has been the reduction in child poverty (the percent of children who live in families below the poverty line) since the last recession, when the rate stood at 22% in 1992. The latest estimate for 1999 finds the child poverty rate has dropped to 16% (Department of Health and Human Services 2001), though this rate is still higher than it was in the 1970s.

## Illinois' tax system

Taxes collected by state and local governments in Illinois do little to mitigate adverse trends in inequality or child poverty. As the Illinois Tax Accountability Project (2001) notes, "Currently, our bottom 20% of income earners pay 13.5% of their total income to the state in taxes, while the wealthiest 1% pay only 4.9% of their total income."

Another failing of the Illinois tax structure is its heavy use of local property taxes to finance education (ITAP 2001). The decentralized finance of education via property taxes means that taxpayers who live in well-off local jurisdictions bear a lower burden than those in lower-income communities. Furthermore, public service costs tend to be higher in less well-off communities, resulting in a tax system with a two-fold adverse impact on the average working family.

On the other hand, Illinois does share part of its state revenue with local governments. More centralized revenue collection helps reduce regressivity and the negative economic consequences for poorer localities. Centralized taxation overcomes the tendency for residence to follow patterns of economic segregation, and it also reduces incentives for businesses to discriminate among locations according to variable local tax rates.

Another strike against Illinois's fiscal system is its higher-than-average retail sales tax rate (6.25%). Giertz and McGuire (1999) discuss one possible solution to this problem, pointing out how a broader tax base would permit reductions in the sales tax rate. Kenyon (1999) describes future problems for the state that could result from erosion of the sales tax base.

The state income tax is not very helpful in this context — Illinois is one of only seven states with a flat rate income tax. Moreover, what is called the "zero bracket amount," the amount of income exempt from tax, is only $2,000 per person. Given that Illinois has no standard deduction (there are, however, some additional deductions for those meeting special circumstances), this exemption level is a paltry income tax threshold (Giertz and McGuire 1999). Exemptions under the federal income tax are currently $2,800 per dependent, so in this respect the Illinois state income tax has a broader statutory base than the federal tax. In other words, for a given person the definition of income subject to tax is broader, notwithstanding the fact that Illinois intends to collect much less revenue within the state.

Illinois' state income tax rate is regulated by its state constitution, which creates important obstacles to any move toward graduated tax rates. The tax does make use of several deductions and credits, and deductions tend to have an effect similar to that of graduated rates. So tradition and consistency would suggest there is no logical or legal obstacle to raising the income tax threshold or adding provisions that render the state tax more progressive, even if the single-rate feature remains.

One particularly regressive feature of the current state tax system is the fall in taxation as income rises, which is the result of the tax code's deductions for property taxes and pension income. Since households with higher incomes tend also to have more valuable property, deductions, in effect, rise with incomes. This tax

regressivity is exacerbated by the fact that landlords can deduct the property tax (as well as mortgage interest) as a cost of doing business without passing along any savings to tenants.

One response to the inadequacies of Illinois' low zero bracket amount could be the introduction of refundable credits in the state income tax. A second remedy would be the expansion of federal tax benefits for working families with children. But neither option necessarily precludes the other—the federal Simplified Family Credit proposal (discussed in detail below) makes a state counterpart easy to implement.

## Illinois' earned income credit

A new state earned income credit takes effect this year in Illinois.[1] The Illinois credit provides eligible taxpayers with 5% of the benefits of the federal Earned Income Tax Credit (EITC). Thus, the maximum possible total benefit for a family with two children is $194. The benefit is not refundable, hence it has no value for a family that owes no income tax. If the credit exceeds the tax, the value of the credit is reduced to that of the tax.

As state credits go, the Illinois "piggyback" credit is among the smallest, with Kansas, the District of Columbia, Colorado, and Massachusetts all having a rate twice as high (10%). Many other states have even higher rates, including Maryland (15%), New York (25%), Rhode Island (26.5%), Vermont (32%), and Wisconsin (a top rate of 43%). Moreover, several other states make the credit refundable.

Here is an example of how the Illinois credit works. Consider a married couple with two children earning a poverty-line income of $17,463. If the parents work the equivalent of 3,000 hours (one full-time and one half-time job), they would earn an average wage of $5.82 an hour, or somewhat higher than the minimum wage. Presently the Illinois exemptions exclude $8,000 of income from tax (the $2,000 zero bracket amount times four), leaving $9,463 subject to the flat rate of 3%, for a state income tax of $284.

The state credit would be about $145 for this family, less than the state income tax (excluding other potential deductions or credits). If not for the federal EITC, the net state income tax of $139 would cause this family's income to slip beneath the poverty line.

Another important concern in shaping the tax code is its effect in terms of making work pay. Take the same family and consider the gains from the first dollar of wages earned. The payroll tax takes out 7.65 cents (double if the employer portion is included). On the first dollar of earnings, there is no income tax from either the federal government or the state. The EITC subsidy rate is 40 cents, so on balance the parent gains 32 cents on top of that first dollar.

Note that initially the state credit is zero, since it is nonrefundable and there is no state tax until earnings exceed $8,000. If the taxpayer's income is high enough to incur some state income tax liability, there will be some range of income where the state credit offsets all state tax liability. In this example, the taxpayer accrues state income tax liability for income over $8,000. The first dollar over $8,000 is taxed at 3%, but the state credit completely offsets the tax at that point. But since the maximum state credit is limited to 5% of the maximum EITC credit, and the state credit phases out with the EITC, there will be some point where the credit is exhausted and the income tax is fully implemented again.

Basically, the pattern of the state tax credit runs as follows:

1. For an initial range of income not subject to state tax, the state credit has no impact because it is nonrefundable.

2. For a limited range of income, the credit magnifies the effect of the EITC, though this is limited by the extent of positive state income tax liability.
3. Where the EITC benefits "max out," the state credit depends completely on the extent of state income tax liability.
4. As the EITC phases out, so too does the state credit, magnifying the negative marginal effect of the EITC. In combination with payroll tax rates and the onset of federal income tax liability, this total effect can be a considerable 48% marginal tax rate (7.65% payroll tax (double with the employer portion); 15% income tax; 21% EITC phase-out; 3% state income tax; and 1% state credit phase-out).

These ranges will vary with the taxpayer's particular circumstances (i.e., income, filing status, number of children, etc.). Part of the difficulty for state governments in seeking to make work pay more is the jumble of federal provisions. The SFC aims to simplify this process and thereby make a state credit easier to design (see Sawicky 2000).

The Illinois state credit has a way to go if the intention is to reduce child poverty and motivate people to work. Its saving grace is that, in choosing between working or not working altogether, the worker is slightly better off working with the state credit than without it.

## What is the Simplified Family Credit?

The Simplified Family Credit folds the federal EITC, Child Tax Credit, Additional Child Credit, and dependent exemption into a single unified refundable credit. (For more details, see Cherry and Sawicky (2000)). The SFC credit phases in like the EITC, but more rapidly and to a higher maximum. It stays at the maximum for a greater range of income than the EITC, and it phases out much more gradually than the EITC. Unlike the EITC, it does not phase out to zero but rather down to $1,300 per dependent child. Benefits increase for each additional child, unlike the EITC, whose benefits are capped at two children.

Other benefits of this proposal include a faster phase-in, higher maximums, and benefits for additional children, all of which help low-wage workers in particular. The slower and limited phase-out benefits middle-class families. The elimination of the phase-outs found in the Child Tax Credit and dependent exemption for high-income families makes for greater equity, since, for any given income level, a taxpayer with children ought to pay somewhat less tax than a taxpayer without children.

The faster phase-in and slower phase-out improve work incentives and reduce the marriage penalties for the many taxpayers presently receiving the EITC. Unification of different provisions simplifies the tax code and eliminates the isolation of EITC recipients, relative to other working families.

## SFC effects on Illinois taxpayers

How would the SFC affect taxpayers in Illinois? **Table 1** shows estimates prepared by Citizens for Tax Justice (2000). The table's second column shows the overall change in taxes for each income group under the SFC. Since the credit is universal, some wealthy households get a tax cut as well, but the extent of tax relief would be a very small share of their total incomes.

**TABLE 1**
**Effects of the Simplified Family Credit on Illinois Taxpayers** (tax year 1999)

| Income | Percent receiving tax cut | Average tax cut for those receiving tax cut | Returns in income class as percent of all returns |
|---|---|---|---|
| $0 - 10,000 | 33.8% | $411.83 | 12.2% |
| 10,000 - 20,000 | 54.0 | 339.55 | 16.6 |
| 20,000 - 30,000 | 58.0 | 684.30 | 15.6 |
| 30,000 - 40,000 | 52.5 | 805.35 | 12.2 |
| 40,000 -50,000 | 37.6 | 1,005.56 | 9.3 |
| 50,000 - 75,000 | 53.6 | 675.67 | 15.8 |
| 75,000 - 100,000 | 46.0 | 336.72 | 8.1 |
| 100,000 - 200,000 | 41.3 | 598.12 | 7.3 |
| Over 200,000 | 43.2 | 1,356.80 | 2.8 |
| **ALL** | **48.0%** | **$611.03** | **100.0%** |

The table's first column shows the percentage of taxpayers in each income group who enjoy a tax cut from the SFC. The cuts are broadly distributed but concentrated in incomes between $10,000 and $75,000.[2]

The tax cuts ("average gains") shown in the second column may seem small, but these are averages for the income class in question. Cuts are much more dramatic for working families with two or more children. **Table 2** provides some comparisons of the SFC with current law and with the Bush Administration proposal to double the Child Tax Credit. It should be also noted that the total cost of the SFC is about one-fourth of the cost of the Bush Administration's plan. Given the simple design of the SFC, it would be easy to provide greater tax relief if the political environment proves to be conducive to such a proposal.

## Conclusion

The flawed tax system of Illinois provides a reason and an opportunity to pursue progressive tax simplification. The SFC's simple design makes a state credit easy to "piggyback" onto the federal credit (see Sawicky 2000). No other tax proposal presently goes as far toward tax simplification, and simplification is crucial for state governments seeking to better support working families with children.

Times of prosperity are opportunities for new initiatives in the public sector. Tax-based benefits for children that have important implications for work incentives and marriage penalties are a good place to begin. The scope of welfare reform—the premise that most families can function effectively in the labor market—magnifies the importance of the need to make work pay. The SFC deserves consideration for all of these reasons. No other proposal currently up for review does nearly as much, if anything, to address these concerns.

**TABLE 2**
**Simplified Family Credit vs. Bush Administration Proposal** *(married couple, two children)*

| Income | Change from current law with SFC | Change from current law with Bush child credit | Advantage of SFC over Bush credit |
|---|---|---|---|
| $10,000 | $612 | - | $612 |
| $15,000 | 788 | - | 788 |
| $20,000 | 838 | - | 838 |
| $25,000 | 888 | - | 888 |
| $30,000 | 1,655 | $718 | 938 |
| $35,000 | 1,660 | 1,000 | 660 |
| $40,000 | 1,410 | 1,000 | 410 |
| $45,000 | 1,160 | 1,000 | 160 |

## Endnotes

1. It may be helpful to understand how the federal EITC works. The EITC is contingent on receiving income in the form of wage and salary, self-employment, or proprietorship. As such income increases, the taxpayer is entitled to a credit equal to a percentage of the income. This subsidy rate depends on the number of dependent children. The credit attains a maximum of $2,353 at an income of $6,900 for one child, and $3,888 at an income of $9,700 for two children. It remains constant until income exceeds $12,700, at which point the credit begins to phase out. At $31,150, the taxpayer no longer qualifies for the credit. For details, see Cherry and Sawicky (2000).

2. These data reflect the effects of a provision of the SFC that has since been removed from the legislation. Because the SFC eliminates phase-outs of the dependent exemption and Child Tax Credit for high-income persons, there is an extra cost of approximately $5 billion annually. In an effort to reduce this cost, a previous version of the legislation included lowering tax brackets for high-income persons. In other words, the tax cut resulting from the elimination of the phase-outs was balanced by a tax increase that would mostly affect taxpayers without children. The tax increase element has since been removed from the legislation.

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