

# THE SEARCH FOR REVENUES TO FILL THE ILLINOIS FISCAL GAP

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# Illinois' Structural Deficit

- A state structural *deficit* when balanced budgets are required?
  - ▣ Inability to maintain service delivery with existing revenue structure
- Serious problems in the Great Recession
  - ▣ Borrowing from the feds to fund UI trust fund
  - ▣ Inability to pay tax refunds to business
  - ▣ Debt carryforward
  - ▣ Imminent loss of ARRA funds will create chasm

# Illinois' Structural Deficit *(continued)*

- But also perennial problems in finding budget balance
- Along with policy choices that have expanded future liabilities w/o increased tax effort
  - ▣ Most poorly funded pension system in the country (Pew Center)
  - ▣ Ranked 12<sup>th</sup> in debt per capita and 16<sup>th</sup> in debt/personal income in 2008 (State Policy Reports)
  - ▣ Second worst bond rating in the country in 2009 (Standard and Poors)

# Structural Deficit Admittedly an Imbalance between Revenues *and* Expenditures

- Budget and policy rules to limit future government growth
  - ▣ TELs, debt limitations, budget commissions
  - ▣ Effective only if binding—is there the will?
- Service cuts likely needed to help plug the fiscal hole, both short term and long term
  
- Focus on revenue side of the ledger...

# Is There Unused Tax Capacity?

- Comparative analysis essential to determine viable policy options
- When compared against some absolute standard?
  - ▣ No, taxes are already too high...just like Tennessee
- When compared against other states?
  - ▣ Standard comparative tax burden analysis would suggest the answer is yes
- Tax Foundation assessment of Illinois
  - ▣ 30<sup>th</sup> in Business Tax Climate
  - ▣ State and local taxpayers “not unduly burdened in 2008”
- Taxes per capita and taxes as a share of personal income are not high by national standards

# Guiding Tax Policy Changes: Characteristics of a Good Tax System

- Revenue...
  - ▣ Yield/adequacy-sufficient to fund services today
  - ▣ Stability-relatively smooth over the business cycle
  - ▣ Elasticity-responsive to economic growth and thus longer-term spending needs
- Fairness...
  - ▣ Vertical equity
  - ▣ Horizontal equity
- Neutrality and (or versus?) competitiveness
  - ▣ Neutrality means a level playing field
  - ▣ In practice neither businesses nor policymakers really want *neutrality*, they want competitive advantages
- Easy to administer, easy to comply with
  - ▣ Note COST gives tax administration in Illinois a D grade

# Policy Goal For Illinois: Revenue Enhancement with Limited Distortions

- Short-run revenue yield to bridge current gaps
- Long-run revenue elasticity to
  - ▣ Promote future budget balance
  - ▣ Minimize future tax increases
  - ▣ Enable support of RDFs
- Keep base and rates within regional and broader interstate bounds
- Address all equity issues with precise targeting of policy to preserve revenues

# Broad Policy Options

- Tax sin, soda, salt and Girl Scout Cookies
  - ▣ Nickels and dimes...ok, many \$millions
  - ▣ Politically popular (especially with Keebler elves)
  - ▣ But not a short-run or long-run solution
- Property tax
  - ▣ Encroaches on primary local revenue source
  - ▣ Local property tax burdens relatively high
    - Minnesota study
    - DC study



# Broad Policy Options *(continued)*

- Business taxes...
- Corporate income tax
  - ▣ Limited revenue capacity
    - Tax planning responses
  - ▣ Hurts business climate
- Alternatives to standard corporate income tax?
  - ▣ Gross receipts taxes like Ohio and Texas
  - ▣ VATs and their many cousins
  - ▣ If pursued, goal should *not* be to raise significantly more revenue

# Broad Policy Options *(continued)*

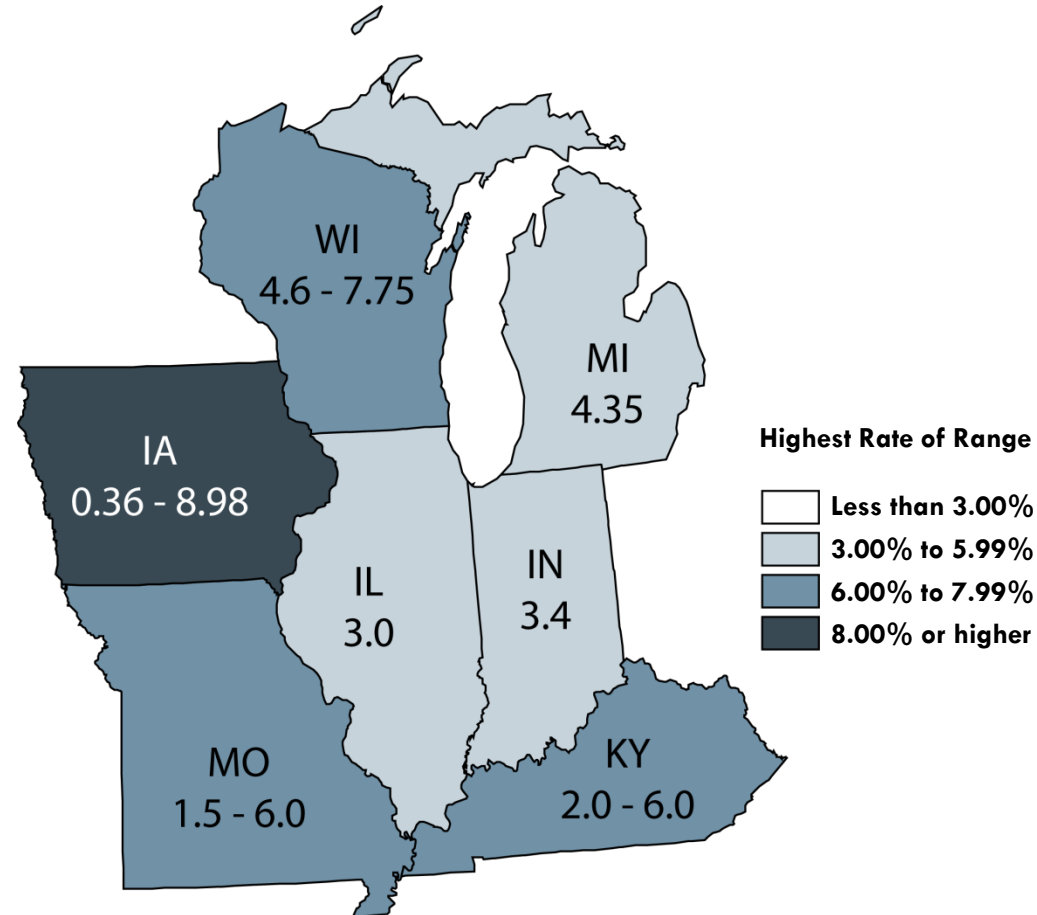
- Personal income tax
  - ▣ Tax rate and comparative burden analysis suggests unused revenue capacity
  
- Sales tax
  - ▣ State plus local rates relatively high
  - ▣ But base is very narrow via exclusion of most services thus additional revenue capacity

# Recommendations

- Guided primarily by yield and elasticity considerations
- Need to demonstrate commitment not gimmicks
- Difficulty of exporting tax burdens
  - ▣ Ultimately Illinois residents must fund the services they consume
    - Or have consumed
    - Or will consume

# State Personal Income Tax Rates

(Tax Rates for Tax Year 2010)



Source: The Federation of Tax Administrators, [http://www.taxadmin.org/fta/rate/ind\\_inc.pdf](http://www.taxadmin.org/fta/rate/ind_inc.pdf)

# Illinois Personal Income Tax

- Raise rate 0.5-1.0 percentage points
  - ▣ **\$1.5-2.0 billion** a crude guess for each half percentage point
  - ▣ Maintain flat rate
  - ▣ Address vertical equity and progressivity by adjusting personal exemption
  
- Bring a portion of SS and retirement income into the tax net
  - ▣ \$984 tax expenditure in 2008
  - ▣ Address vertical equity via targeting relief
  - ▣ **\$500 million** in new revenue? (another guess)

# Impose Sales Tax on Food, Drugs and Medical Appliances

- \$1.4 billion tax expenditure in 2008
  - ▣ Would simplify administration and compliance v. existing 1% rate
    - Gummi Bears v. Twix bars
  - ▣ Poorly targeted so all receive relief, including the wealthy & visitors
    - 1% on Spam and canned beans
    - 1% on lobster and chateaubriand
  - ▣ Recognize that food stamp recipients do not pay sales tax on food under current policy

# Target Relief to Protect Revenue

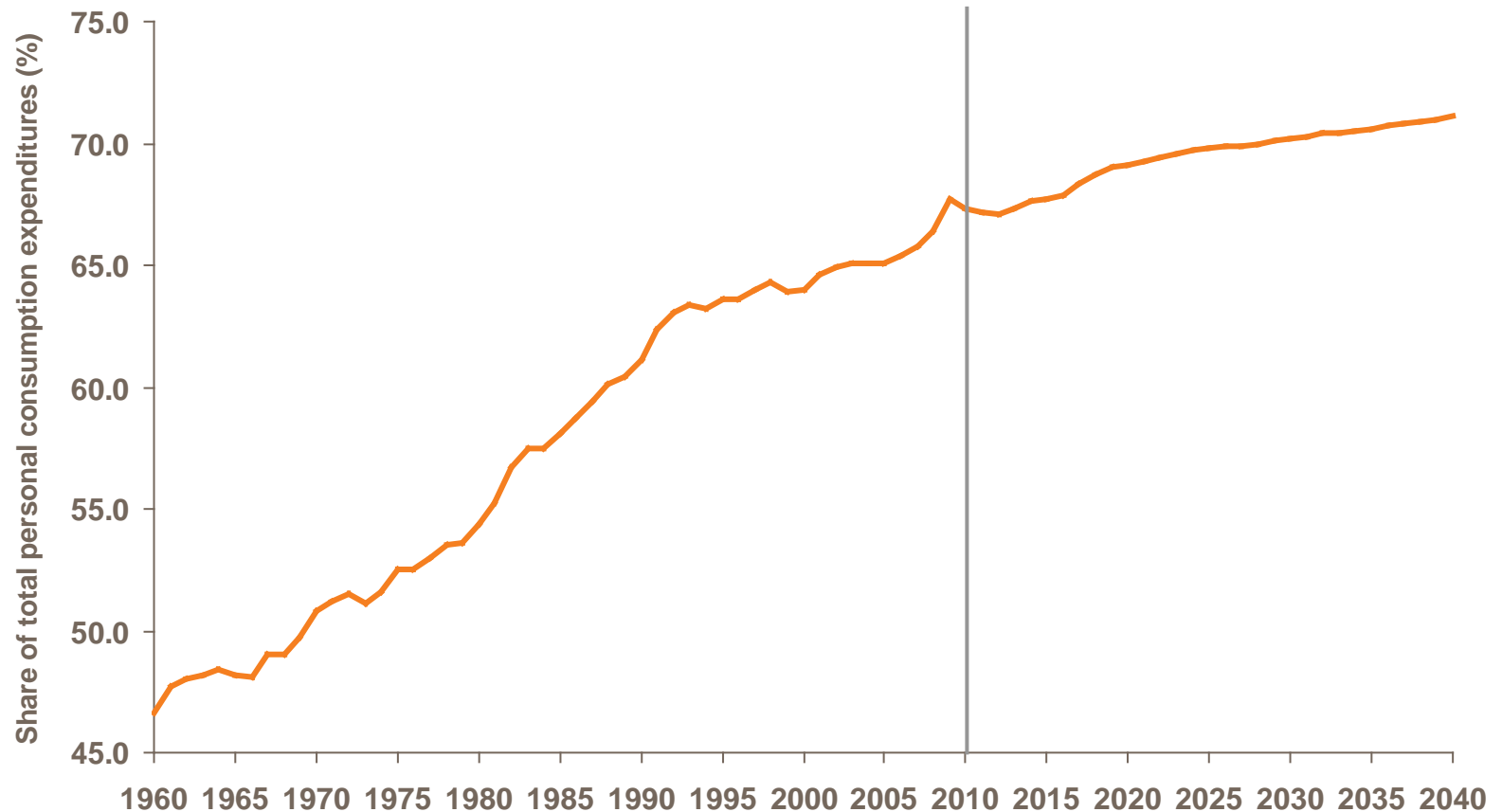
- Refundable income tax credits for low income taxpayers
- Or smartcards enabling direct sales tax credits at point of purchase to address illiquidity
- Concerns?
  - ▣ Inability to complete tax return & nonfilers
  - ▣ Stigma associated with Smartcards like that with food stamps
  - ▣ Smartcard fraud
- Do these concerns justify as much as **\$1 billion** in forgone revenue from poor targeting (another guess)?

# Broaden Sales Tax Base to Include Consumer Services

- Add service losses to Tax Expenditure Report so they are explicit
- Services are non-tradable and require direct contact between buyer/seller limiting distortions
  - ▣ Not a remote sales problem where a zero tax rate might apply
  - ▣ But a cross-state border-shopping issue where in-state v. out-of-state rate is relevant
- Enhances yield and elasticity

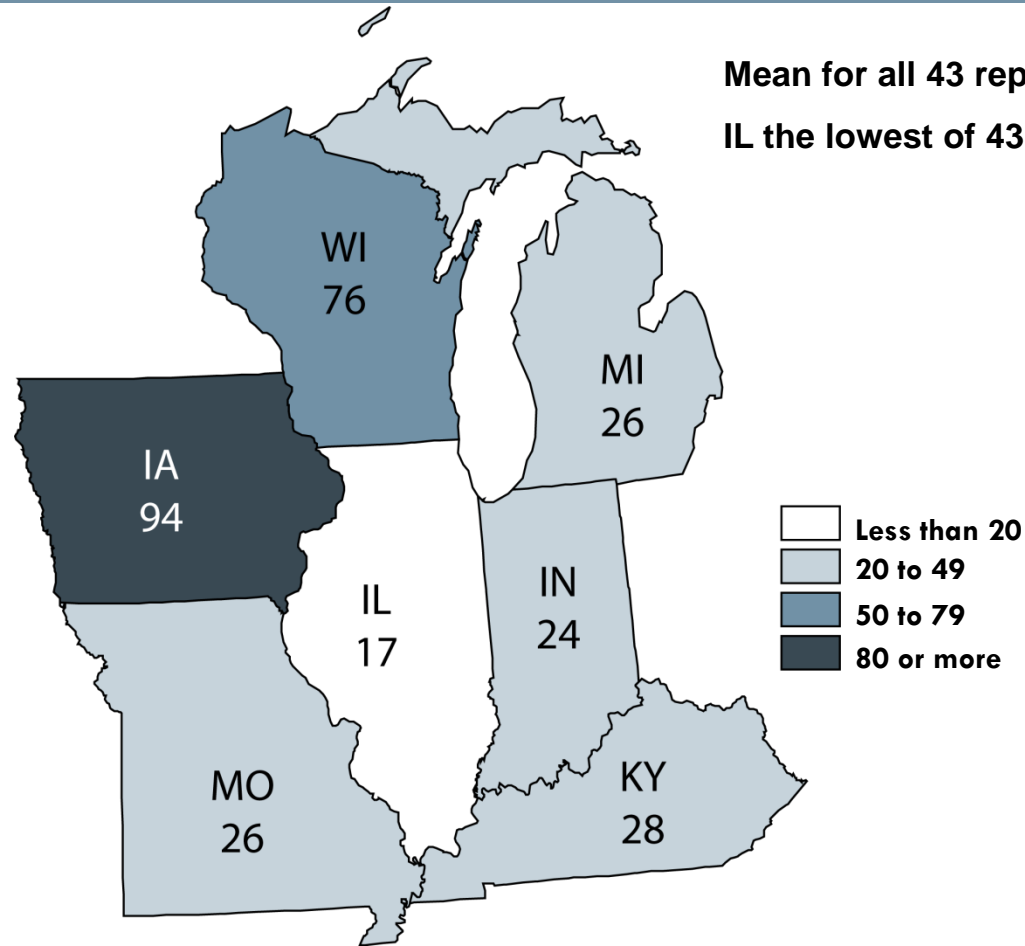


# Nominal Consumer Spending Share on Services, 1960 to 2040



Source: IHS Global Insight, Inc.

# Ample Capacity: Number of Services Taxed by Regional States



Mean for all 43 reporting states: 59

IL the lowest of 43 reporting states

Source: The Federation of Tax Administrators.

# Some Examples on Possible Base Expansion (2002 IL Census of Services)

- Drycleaning and laundry net of linen supply and industrial launderers
  - ▣ \$543.6 m
- Auto repair and maintenance
  - ▣ \$3.8 million
- Consumer electronics repair and maintenance
  - ▣ \$64.1 million
- Personal and household goods repair and maintenance
  - ▣ \$612.9 m
- Personal care services
  - ▣ \$967.9 m
- Parking lots and garages
  - ▣ \$420.9 m
- Center for Tax and Budget Accountability yield estimate-
  - ▣ \$1.7 billion from *all* consumer services at 5.0 percent rate

# Some Basic Principals in Taxing Services

- Don't bother with small fish
  - ▣ Leave fishing guides and taxidermists alone
  - ▣ High administrative and compliance costs relative to revenue
  - ▣ Ease of noncompliance
- Provide firms with exemptions on business-to-business services transactions
- Any concerns over equity should be addressed outside of the sales tax via targeted relief

# Summary

- Illinois has lost credibility because of its inability to manage fiscal affairs
  - ▣ Stigma & uncertainty over future tax policy will hurt competitiveness
- Structural deficit must be addressed via commitment, not gimmicks
- Ultimately residents must pay the price since tax exporting is not realistic—but which generation?
- Ample unused tax capacity under the PIT and sales tax that if exploited would (i) help resolve current and future fiscal imbalances and (ii) not seriously hamper economic development prospects for the state

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