STATE OF ILLINOIS CONSTITUTIONAL CONVENTION FISCAL ISSUES

An Issue Brief

Prepared by the Civic Federation

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STATE OF ILLINOIS
CONSTITUTIONAL CONVENTION FISCAL ISSUES

This paper provides a brief overview of selected state and local fiscal issues that could be considered by a new Constitutional Convention. The presentation is by no means exhaustive. **The proposals listed in this paper do not necessarily reflect positions of the Civic Federation**. They are intended for discussion purposes as stakeholders consider the implications of holding a new Constitutional Convention.

I. STATE OF ILLINOIS FISCAL ISSUES

The first section discusses selected state budget and revenue issues that could be addressed by a Constitutional Convention. Many of these proposals could be enacted by statute at this time. The possible reforms presented include:

- Imposing a legislative supermajority requirement for budget approval;
- Limiting spending and tax increases;
- Changing the structure of the state income tax; and
- Eliminating the constitutional guarantee for public pensions.

Another possible constitutional change would be earmarking a portion of appropriations or revenues for specific policy areas like education. This option is not discussed as it is the subject of a separate Constitutional Convention forum that will be presented in May 2008 by the Civic Federation and the Union League Club.

STATE BUDGET PROCESS

Article VIII – Finance - Section 2. State Finance

(a) The Governor shall prepare and submit to the General Assembly, at a time prescribed by law, a State budget for the ensuing fiscal year. The budget shall set forth the estimated balance of funds available for appropriation at the beginning of the fiscal year, the estimated receipts, and a plan for expenditures and obligations during the fiscal year of every department, authority, public corporation and quasi-public corporation of the State, every State college and university, and every other public agency created by the State, but not of units of local government or school districts. The budget shall also set forth the indebtedness and contingent liabilities of the State and such other information as may be required by law. Proposed expenditures shall not exceed funds estimated to be available for the fiscal year as shown in the budget.

(b) The General Assembly by law shall make appropriations for all expenditures of public funds by the State. Appropriations for a fiscal year shall not exceed funds estimated by the General Assembly to be available during that year.

The Illinois Constitution includes provisions that require a balanced budget and impose supermajority requirements for budget approval after the legislature's scheduled adjournment date of May 31.

The Constitution requires that the Governor's proposed budgetary expenditures cannot exceed resources estimated for the fiscal year and that the General Assembly cannot make appropriations in excess of estimated resources. All states except Vermont have similar constitutional or statutory requirements. Forty-three states require that the governor's budget be balanced, 39 states require the budget passed by the legislature be balanced and 37 states require that the budget must be balanced at the end of a fiscal year or biennium.[1]

Practices in Other States

Supermajority Requirements for Budget Approval

The Illinois State budget must be proposed by the Governor by the third Wednesday in February.[2] Prior to its adjournment date of May 31, the General Assembly must approve the budget by simple majority vote. After May 31, the budget must be approved by a three-fifths vote.[3]

Five states in addition to Illinois require a supermajority affirmative vote of the legislature to approve the budget in certain circumstances. These states are Connecticut, Hawaii, Maine, Mississippi and Nebraska. The reasons for a supermajority vote are that the regular legislative session has ended or the debt ceiling has been reached.[4]

Three states require a supermajority vote at all times to pass a budget:[5]

- California requires a 2/3rds affirmative legislative vote for non-educational general fund appropriations. As the legislature usually approves a single budget bill, the provision de facto applies to the entire budget in most years.

- Arkansas requires a 3/4ths majority on appropriations for all purposes except education, highways and debt. Appropriations for those three purposes require a simple majority.

- Rhode Island requires a 2/3rds affirmative vote for local or private purposes. As the legislature usually approves a single budget bill, the provision de facto applies to the entire budget in most years.

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[1] National Conference of State Legislatures. State Balanced Budget Requirements: Executive Summary, Updated April 12, 1999 at www.ncsl.org/programs/fiscal/balreqs.htm.
[2] 15 ILCS 20/50-5.
[3] Illinois State Constitution, Section IV, Article IV, section 10. Effective Date of Laws.
[4] National Conference of State Legislatures. "Supermajority Requirements to Pass the Budget," A Legisbrief, November/December 1998. Volume 6, No. 48.
[5] National Conference of State Legislatures. "Supermajority Requirements to Pass the Budget," A Legisbrief, November/December 1998. Volume 6, No. 48.

Discussion:

Supermajority requirements are intended to control spending or limits certain type of spending. Achieving a supermajority affirmative vote on the State budget requires forging a consensus on fiscal matters as the views of the minority political party and all regions of the State have to be considered.

Possible Proposal:

- Require a supermajority affirmative vote of the General Assembly to approve the State budget (prior to the adjournment date of May 31). The supermajority vote could be designated as a 3/5ths vote or a 2/3rds vote. Supermajority requirements can make it difficult to achieve a consensus on the budget and grant enormous power to small groups of lawmakers to thwart the will of the majority.

STATE TAX AND EXPENDITURE LIMITS

The Illinois Constitution places no structural limits on the ability of the General Assembly to raise taxes or increase spending with two exceptions: the state income tax must be a flat rate tax and the rate imposed on corporations cannot exceed the individual rate by a ratio of more than 8 to 5.[6] Many other states in contrast require: 1) supermajority votes of the legislature to approve tax increases, 2) limit revenue increases, 3) restrict spending increases or 4) some combination of the preceding.

Practices in Other States

Supermajority Requirements to Approve Tax Increases

Sixteen states require a supermajority affirmative vote of the legislature to raise all or certain taxes. Five states impose a 60% threshold, eight require a two-thirds affirmative vote and three mandate a 75% threshold.

STATES REQUIRING SUPERMAJORITY LEGISLATIVE APPROVAL OF REVENUE INCREASES

3/5ths Supermajority	2/3rds Supermajority	3/4ths Supermajority
Delaware	Arizona	Arkansas
Florida	California	Michigan
Kentucky	Colorado	Oklahoma
Mississippi	Louisiana	
Oregon	Missouri	
	Nevada	
	South Dakota	
	Washington	

Source: Tax Policy Center. Allison McCarthy and Elaine Maag, "Limits on State Revenue," from *Tax Notes*, July 31, 2006, p. 443.

[6] Article IX, Section 3 – Limitations on Income Taxation.

Revenue Limits

Six states impose specific limitations on revenues. The constitutions of Florida, Michigan and Missouri limit tax increases to personal income growth.[7] Massachusetts limits revenues by statute to inflation increases. Oregon's constitution requires a refund of General Fund revenues in excess of 2% of revenue projections at the time the budget was approved by the legislature. Finally, Colorado's constitution has the most stringent limitations. It limits revenue increases to a factor based on population growth plus inflation. Changes to the revenue limits must be approved by the voters. The revenue limitation has been suspended until 2011 by an affirmative vote of the people.[8]

Expenditure Limits

Twenty-three states limit annual increases in budgetary spending. These restrictions are often tied to increases in personal income. Several states cap increases based on an index that combines several economic factors, such as personal income and population growth.[9]

STATE EXPENDITURE LIMITS		
Constitutional Limits on Spending	**Statutory Limits on Spending**	**Both Constitutional and Statutory Limits on Spending**
Alaska	Idaho	Colorado
Arizona	Indiana	Connecticut
California	Maine	
Hawaii	Montana	
Louisiana	Nevada	
Oklahoma	New Jersey	
South Carolina	North Carolina	
Tennessee	Ohio	
Texas	Oregon	
	Utah	
	Washington	
	Wisconsin	

Source: National Conference of State Legislatures. *State Tax and Expenditure Limits - 2007.*

Appropriations Limited to a Percentage of Revenue Estimates

Five states limit annual appropriations to the amount estimated by the annual revenue forecast: Delaware, Iowa, Mississippi, Oklahoma and Rhode Island. The limit ranges from 59% to 99% of the forecasted revenue amount.[10]

[7] Florida limits revenue growth to the average growth rate in state personal income for the 5 previous years; Michigan limits revenue to a proportion of total State personal income; and Missouri limits revenue to a 5.64% of the previous total state personal income.
[8] National Conference of State Legislatures. "State Tax and Expenditure Limits" September 2007 – see www.nscl.org/programs/fiscal/tels2007.htm.
[9] National Conference of State Legislatures. "State Tax and Expenditure Limits" September 2007 – see www.nscl.org/programs/fiscal/tels2007.htm.

[10] National Conference of State Legislatures. "State Tax and Expenditure Limits" September 2007 - see www.nscl.org/programs/fiscal/tels2007.htm.

Discussion:

Budget and revenue limitations are intended to restrain growth in government spending. A majority of states now have imposed such restrictions on tax growth, budgetary growth or a combination of both.

Possible Proposals:

1. Impose a supermajority requirement to approve tax increases.
2. Limit tax increases to personal income growth or annual inflation increases.
3. Limit annual spending plan to personal income growth or an index combining several economic factors.
4. Limit annual appropriations to a percentage of the annual revenue estimate.

<u>All of these proposals would curtail spending by limiting access to revenue growth. However, they would also have the impact of restricting state flexibility to raise revenues adequate to meet financial challenges and could hamper efforts to diversify the revenue base by adopting new revenues.</u>

STRUCTURE OF THE STATE INCOME TAX

Article IX – Revenue – Section 3. Limitations on Income Taxation.

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 rate shall not exceed the rate imposed on individuals by more than a ratio of 8 to 5.

The Illinois Constitution provides for a flat rate income tax on individuals and corporations. The corporate tax rate cannot exceed the personal tax rate by a ratio of more than 8 to 5.

<u>Practices in Other States</u>

Illinois is one of six states that have a flat individual income tax rate. The Illinois tax rate of 3.0% is the lowest rate imposed in these states. Thirty-five states impose graduated rates. The graduated tax rates vary widely, from a low of 0.36% for certain taxpayers in Iowa to a high of 9.5% in Vermont.[11] Nine states do not impose an individual income tax.

[11] Federation of Tax Administrators at www.taxadmin.org/fta/rate/ind_inc.html.

STATE PERSONAL INCOME TAX STRUCTURES			
Graduated Tax Rates		**Flat Tax Rate**	**No Income Tax**
Alabama	Montana	Colorado - 4.63%	Alaska
Arizona	Nebraska	**ILLINOIS- 3.0%**	Florida
Arkansas	New Jersey	Indiana - 3.4%	Nevada
California	New Mexico	Massachusetts - 5.3%	New Hampshire*
Connecticut	New York	Michigan - 3.9%	South Dakota
Delaware	North Carolina	Pennsylvania - 3.07%	Tennessee*
Georgia	North Dakota		Texas
Hawaii	Ohio		Washington
Iowa	Oklahoma		Wyoming
Kansas	Oregon		
Kentucky	Rhode Island		
Louisiana	South Carolina		
Maine	Utah		
Maryland	Vermont		
Minnesota	Virginia		
Mississippi	West Virginia		
Missouri	Wisconsin		

Source: Federation of Tax Administrators at www.taxadmin.org/fta/rate/ind_inc.html

*Income Tax on Dividends and Interest Income Only

The next exhibit shows corporate income tax rates in the 50 states. In contrast to personal income tax structures, more states impose flat rate corporate income taxes rather than graduated rates. In all, thirty states have authorized a flat rate corporate income tax. These flat rates range from 4.0% in Kansas to 9.99% in Pennsylvania. The Illinois corporate income tax rate is 4.8%. However, corporations also pay the 2.5% personal property replacement tax (PPRT), which is essentially an additional business income tax. Therefore, the composite business tax rate is 7.3%.

Thirteen states currently impose graduated corporate income taxes, ranging from a low of 1.0% for certain businesses in Alaska and Arkansas to a high of 12.0% for selected businesses in Iowa. Six states have no corporate income tax.[12]

[12] Federation of Tax Administrators at www.taxadmin.org/fta/rate/corp_inc.html.

STATE CORPORATE INCOME TAX STRUCTURES			
Graduated Tax Rates	**Flat Tax Rate**		**No Income Tax**
Alaska	Alabama - 6.5%	Missouri - 6.25%	Michigan
Arkansas	Arizona - 6.968%	Montana - 6.75%	Nevada
Hawaii	California - 8.84%	New Hampshire - 8.5%	South Dakota
Iowa	Colorado - 4.63%	New Jersey - 9.0%	Texas
Kentucky	Connecticut - 7.5%	New York - 7.5%	Washington
Louisiana	Delaware - 8.7%	North Carolina - 6.9%	Wyoming
Maine	Florida - 5.5%	Oklahoma - 6.0%	
Mississippi	Georgia - 6.0%	Oregon - 6.6%	
Nebraska	Idaho - 7.6%	Pennsylvania - 9.99%	
New Mexico	**ILLINOIS - 4.8%***	Rhode Island - 9.0%	
North Dakota	Indiana - 8.5%	South Carolina - 5.0%	
Vermont	Kansas - 4.0%	Tennessee - 6.5%	
Maine	Maryland - 7.0%	Virginia - 6.0%	
	Massachusetts - 9.5%	West Virginia - 8.75%	
	Minnesota - 9.8%	Wisconsin - 7.9%	

Source: Federation of Tax Administrators at www.taxadmin.org/fta/rate/corp_inc.html

*Corporations also pay a 2.5% Personal Property Replacement Tax

Discussion:

Graduated or progressive income taxes affect higher income earners at proportionally greater rates than lower income earners. The argument for graduated tax rates is that higher income earners have a greater amount of disposable income and thus have a greater ability to pay taxes. The effect of graduated rates can be provided through a system of graduated exemptions.

Flat rate income tax systems provide for the same rate for all taxpayers regardless of ability to pay. Thus, they proportionately have a greater financial impact on lower income earners. They are justified on the basis of providing a fair and transparent tax structure.

Illinois first adopted a flat rate state income tax in 1969. The new tax was proposed and championed by then Governor Ogilvie. Delegates at the Constitutional Convention debated three questions related to the income tax: 1) whether there should be graduated rates; 2) whether individual and corporate tax rates should be linked; and 3) whether maximum rates should be specified. In the end, a political compromise resulted in the approval of the current flat rate income tax system and the linkage between corporate and personal income tax rates. The proposal to establish an individual maximum rate of 5% was defeated.[13]

Possible Proposals:

1. To establish a graduated state income tax.

2. To abolish the linkage between personal and corporate income tax rates.

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[13] Joyce D. Fishbane and Glenn W. Fisher. *Politics of the Purse: Revenue and Finance in the Sixth Illinois Constitutional Convention*. (Urbana: University of Illinois Press, 1974), pp. 145-152.

3. To establish a limit on the personal (and/or corporate) income tax rate.

A majority of states have adopted graduated income tax structures in order to provide a measure of vertical equity into their tax systems. However, flat rate tax structures are often perceived as fair, taxing everyone equally. Political opposition to de-coupling individual and business tax rates would be strong.

PENSION BENEFIT PROTECTIONS FOR STATE AND LOCAL EMPLOYEES

Article XIII – General Provisions, Section 5. Pension and Retirement Rights

Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

The Illinois Constitution provides that the pension benefits for current state or local public employees may not be reduced or eliminated. The contractual relationship commences when an employee enters public service.[14] At the 1970 Constitutional Convention, the provision was approved on a 57-36 vote.[15] The Illinois Supreme Court has found that this provision only relates to the contractual rights of pensioners – it does not obligate the State of Illinois to fund the retirement systems at a particular level.[16] The constitutional provision does not prohibit reductions in benefits for newly hired employees nor does it apply to ancillary benefits such as health insurance.

Practices in Other States

Illinois is one of 14 states with explicit state constitutional guarantees for public employee pensions:

States with Constitutional Protection for Public Pensions	
Alabama	Illinois
Alaska	Kentucky
Arizona	Louisiana
Colorado	Michigan
Florida	New Mexico
Georgia	New York
Hawaii	Texas

Source: National Association of Retirement Administrators at www.nasra.org/resources/pension protections.pdf

In 33 states, there is statutory protection for public pension benefits or the courts have ruled that there are safeguards based on due process rights or federal constitutional protection from the

[14] McNamee, 672 N.E. 2d at 1162; In re Marriage of Menken, 778 N.E. 2d 281, 284 (Ill. App. Ct. 2d District, 2002).
[15] Record of Proceedings, Sixth Illinois Constitutional Convention, p. 2933.
[16] McNamee, 672 N.E. 2d at 1162, People ex. rel. Illinois Federation of Teachers v. Lindberg, 326 N.E. 2d 749, 751 (Ill. 1975), cert. denied, 423 U.S. 839.

impairment of contracts. While pensions historically were viewed as gratuities, legal doctrines have since changed to recognize public pensions as contractual obligations.[17] In only three states – Indiana, Nebraska and New Jersey – has there been no definitive action taken to date on the nature of pension protection.[18]

Discussion:

The explicit constitutional protection for public pension benefits is often cited as a political impediment to restructuring pension benefits. State and local public employees can and do successfully win legislative approval for benefit increases without concern for the fiscal implications for the public treasury. Because benefits are constitutionally guaranteed, they must be paid. Thus, there is little interest or incentive by employees to accept or support any changes to existing retirement systems.

Possible Proposals:

1. To eliminate the explicit constitutional protection for public pension benefits. <u>However, as the experience of other states shows, pension benefits are usually seen as contractual guarantees which cannot be impaired or diminished. So, removing the constitutional protection may have no impact on changing the structure of public retirement plans.</u>

2. To retain the constitutional protection for pension benefits for current employees but constitutionally mandate full funding of retirement benefits. <u>There is currently a statutory requirement for funding the state pension at a 90% level by 2045, but the General Assembly can and has exercised discretion in changing the law to reduce pension payments. A constitutional requirement would eliminate that discretion.</u>

3. Amend Article IX, section 9 (a) to include "pension obligations" in the definition of state debt. An additional requirement could be included requiring all debt to be amortized for a period no longer than thirty years. <u>If pension were constitutionally defined as a debt of the State, the State would be required to provide funding for that obligation over time as it does for long-term debt issues. It would no longer be possible to change pension "debt service" payments.</u>

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[17] McGrath v. Rhode Island Retirement Board, 88 F.3d 12 (1st Cir. 1996).
[18] www.nasra.org/resources/pension protections.pdf.

II. LOCAL GOVERNMENT FISCAL ISSUES

The second section discusses selected local government fiscal issues that could be addressed by a Constitutional Convention. Many of these proposals could be enacted currently by statute. The possible reforms presented include:

- Expanding tax and/or spending limits to all local governments;
- Altering or abolishing property assessment classification;
- Allowing local option income taxes; and
- Expanding revenue capabilities of non-home rule governments or giving them more flexibility to manage existing resources.

Another possible constitutional change would be earmarking a portion of appropriations or revenues for specific policy areas like education. This option is not discussed as it is the subject of a separate Constitutional Convention forum.

EXPANDING TAX AND/OR SPENDING LIMITS TO ALL LOCAL GOVERNMENTS

Article VII - Local Government. Section 7. Counties And Municipalities Other than Home Rule Units

Counties and municipalities which are not home rule units shall have only powers granted to them by law…

Article VII - Local Government. Section 8. Powers and Officers of School Districts and Units of Local Government Other than Counties and Municipalities

Townships, school districts, special districts and units, designated by law as units of local government, which exercise limited governmental powers or powers in respect to limited governmental subjects shall have only powers granted by law.

Illinois non-home rule governments may only exercise those powers authorized by the General Assembly. These governments may only access a limited number of revenues. They cannot impose sales or income taxes. Consequently, they rely heavily on property taxes as a primary source of funds.

In 1991, the General Assembly approved the Property Tax Extension Limitation Law commonly referred to as the "tax cap" law. The law limited annual increases in non-home rule government property tax levies in the six counties of northeastern Illinois to 5% or the rate of inflation, whichever is less.[19] Other Illinois counties have the ability to adopt tax caps by referendum. To date, 33 counties have approved tax caps via referendum, bringing the total number of counties under the tax cap law to 39 of the 102 counties in the state.

[19] 35 ILCS 200/18-185 through 35 ILCS 200/18-245. The taxable value of new properties is exempt from the tax cap for the single year in which they are assessed, thus their value is excluded from the tax cap calculation for that year.

Many home rule governments such as the City of Chicago also have adopted voluntary tax cap ordinances. Chicago approved an ordinance in 1993 that mirrors the State tax cap law. [20] However, the City set aside its voluntary tax cap and approved a 12.0%, $86 million property tax increase as a part of its FY2008 budget.[21] This action illustrates the tenuous nature of voluntary tax caps adopted by home rule governments.

In addition to tax caps, state law in Illinois also imposes property tax rate limitations on non-home rule governments. These rate limits specify the highest real estate tax rate that can be used to raise revenues for particular funds, such as a school district's Education Fund (used for general operations). Rate limits can be increased by popular referendum.[22]

Practices in Other States

Local Government Tax and Expenditure Limitations in the States

Many states impose a variety of tax and expenditure limitation on local governments. Reflecting widespread discontent with property taxes, the most common types of limitations are those on local property taxes. Specific property tax rate limitations are imposed in 33 states, 28 states have approved property tax revenue limits, and 12 states have enacted general property tax rate limits. Revenue and/or expenditure limits are much less common. Only 8 states place general spending limits on local governments and 4 states limit revenues.[23]

Regional Distribution of Local Government Tax & Expenditure Limitations

Type of Limitation	Northeast (9 States)	Midwest (12 States)	South (16 states)	West (13 States)	U.S. Total
Overall Property Tax Rate Limit	0	2	3	7	12
Specific Property Tax Rate Limit	3	10	9	11	33
Property Tax Revenue Limit	4	8	6	10	28
Assessment Increase Limit	1	2	4	5	12
General Revenue Limit	0	2	0	2	4
General Expenditure Limit	1	4	0	3	8
Total Number of Limitations	**9**	**28**	**22**	**38**	**97**

Source: Adapted from table in David R. Mullins, "The Imposition and Effects of Local Government Tax and Expenditure Limitations," Prepared for the Georgia Budget and Policy Institute, January9, 2008.

[20] City of Chicago Municipal Code Chapter 3-92.
[21] Gary Washburn. "Daley offers city's help for homeowners fighting property-tax assessments. Move comes months after Chicago raised levy by $86 million." *Chicago Tribune*, March 5, 2008.
[22] Theodore Swain, et al. *Report of the Civic Federation Task Force on Cook County Classification and Equalization* (Chicago: The Civic Federation, June 1999), p. 13.
[23] David R. Mullins, "The Imposition and Effects of Local Government Tax and Expenditure Limitations," Prepared for the Georgia Budget and Policy Institute, January 9, 2008.

Discussion:

Recent large tax increases in northeastern Illinois have raised concerns about the ability or political will of local home rule governments to contain spending. A case in point is the outcry over Cook County's recent sales tax increase, which will create a composite rate of 10.25% in Chicago, the nation's highest large metropolitan sales tax rate. In 1991, the impetus for imposing tax caps in Illinois was public concern over mounting property tax burdens. In many other states, political resistance to tax and/or spending increases has led to the imposition of constitutional or statutory limitations on local governments' fiscal authority.[24]

There are several counterarguments to efforts to restrict local government fiscal abilities.

- Fiscal issues are more appropriately decided through the democratic political process;
- Enshrining restrictions in law is a long-term proposition that can place a straitjacket on future community needs. It is difficult to reverse a structural decision, particularly if it is an integral part of a state constitution;
- Structural limitations can lead to trade-offs that may not be welcomed. For example, the approval of Proposition 13 which limited local government property taxes in California has led to a shift in state funding of schools to the state government. This has, in reduced local control over public education;
- In Illinois, imposing fiscal restrictions on home rule governments would be a major reversal of the home rule powers currently afforded to these governments under the 1970 Illinois Constitution; and
- Imposing fiscal limitations on home rule governments could have a serious negative impact on those governments' bond ratings as their revenue raising abilities would be curtailed.

Possible Proposals:

1. Extend the Property Tax Extension Limitation law to all local governments in Illinois, including home rule counties and municipalities.

2. Impose annual expenditure limitations on home rule governments.

3. Extend the Property Tax Extension Limitation law to all local non-home rule governments in Illinois.

PROPERTY ASSESSMENT CLASSIFICATION

Article IX – Revenues. Section 4 (b). Real Property Taxation

Subject to such limitations as the General Assembly may hereafter prescribe by law, counties with a population of more than 200,000 may classify or continue to classify real property for purposes of taxation. Any such classification shall be reasonable and assessments shall be uniform within each class. The level of assessment or rate of tax of the highest class in a county shall not exceed two and one-half times the level of assessment or rate of tax of the lowest class

[24] J. Richard Aronson and Eli Schwartz, editors. *Management Policies in Local Government Finance*. (Washington, D.C., International City/County Management Association, 2004), p. 91.

in that county. Real property used in farming in a county shall not be assessed at a higher level of assessment than single family residential real property in that county.

The 1870 Illinois Constitution provided for uniform assessment of property for taxation purposes. However, political considerations led to the development of an assessment system in Cook County that assessed property at different proportions of market value according to use. This *de facto* classification system assessed business properties at higher levels than residential properties.[25] The system introduced an element of progressivity into the property tax system, effectively shifting the burden of property taxation from residential homeowners to businesses. The move was justified with the argument that businesses were more able to pay a higher proportion of taxes than individuals as they can shift the burden in part to customers.

Explicitly authorizing classification was essential to winning approval of the 1970 Constitution by the Cook County delegation to the Constitutional Convention. Consequently, the Constitution did in fact codify the *de facto* classification system in Cook County and permitted it in other counties with populations over 200,000.[26] The Constitution provided that the difference between the assessment level or tax rate between the highest and lowest class could be no more than a ratio of 2.5 to one.

No county other than Cook has chosen to enact a real property classification system to date. Thus, Illinois effectively has two different assessment systems, one for Cook County and another for the remaining 101 counties which assess all property at 33.3% of market value. Cook County has revised the assessment levels several times since 1970. An issue has arisen over time regarding the differential between the assessment levels required by Cook County ordinance versus actual assessment levels. The Illinois Department of Revenue annually conducts assessment/sales ratio studies showing that various assessment classes have been valued at less than the ordinance level percentages of fair market value.[27] At times, the disparity has raised concerns that the constitutionally required limit of 2.5 to one between the highest and lowest classes has been violated. However, the most recent assessment/sales ratio study indicates that this is not currently the case although underassessment persists across classes.[28]

Discussion:

Classification of real property is often criticized on the grounds that it inhibits economic development or is a major structural barrier to statewide property tax reform.

Many argue that assessing business property at higher rates than residential property places an unfair financial burden on Cook County businesses, forcing them into a competitive

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[25] Theodore Swain, et al. *Report of the Civic Federation Task Force on Cook County Classification and Equalization* (Chicago: Civic Federation, 1999), p. 19.
[26] Joyce D. Fishbane and Glenn W. Fisher. *Politics of the Purse: Revenue and Finance in the Sixth Illinois Constitutional Convention*. (Urbana: University of Illinois Press, 1974), pp. 74-75.
[27] The Illinois Department of Revenue reports that median levels of assessment for certain property classes diverge significantly from the ordinance levels due to underassessment. The Civic Federation. *Effective Property Tax Rates: Selected Municipalities in Northeastern Illinois*. October 4, 2007.
[28] The 2005 Illinois Department of Revenue assessment/sales ratio study indicated that that for the Chicago assessment district of Cook County there was roughly a 1:2 ratio between the median level of assessment for the residential class (0.0743) versus the highest class, the commercial class (0.1451). See . The Civic Federation. *Estimated Full Value of Property in Cook County*. October 4, 2007.

disadvantage vis-à-vis businesses in other counties. Thus, it has a negative impact on economic development in the state's most populous county.[29]

Others argue that the classification system is a major barrier to implementing statewide reforms that would reduce property taxes in return for increases in other taxes such as the income tax. Governor Edgar's 1997 effort to reduce local property taxes for education by shifting some of the cost to an increased state income tax was negatively impacted by concerns that such a tax swap could result in a windfall for Cook County businesses who would disproportionately benefit from such a change as they paid a larger share of property taxes under the classification system.

Possible Proposals:

1. Abolish classification of real property for purposes of taxation. Illinois would no longer have two property assessment systems. However, abolishing classification would dramatically shift tax burden in Cook County to residential taxpayers, making such a proposal politically difficult.

2. Base classification on actual levels of assessment. The classification levels could be readjusted to reflect current assessment/sales ratios. This could reduce the ratio permitted between highest and lowest class, reflecting practice.

LOCAL OPTION INCOME TAXES

Article VII, Section 6 (e) – Local Government. Powers of Home Rule Units

A home rule unit shall have only the power that the General Assembly may provide by law…(2) to license for revenue or impose taxes upon or measured by income or earnings or upon occupations.

The Illinois Constitution's local government article provides broad discretion to home rule municipalities and counties to impose a wide variety of taxes. However, there are three limitations to this grant of power:

- Home rule units of government are prohibited from levying an income tax unless the General Assembly gives its express permission. This has never occurred.
- In 1991, the General Assembly preempted local governments' ability to impose retail sales taxes, instead reserving to the State the power to impose a single uniform statewide sales tax. At the same time, however, the legislature did authorize home rule units of government to levy sales taxes in addition to the state sales tax in increments of 0.25%.
- Home rule governments must seek referendum approval for increases in local real estate transfer taxes (unless the General Assembly provides for authorization as it did in the recent funding reforms of the Regional Transit Authority).[30]

[29] Scott Koenemann. "Property Tax Classification in Cook County, Illinois." Lincoln Land Institute of Land Policy, January 2000, p. 2. www.lincolninst.edu/pubs/PubDetail.aspx?pubid=317.
[30] The information in this paragraph is from City of Geneva Administrative Service Department. *Home Rule in Illinois: A Resource Guide for the City of Geneva*, June 3, 2006, pp. 27-28

Local Option Income Taxes in the United States

Ten states permit local governments to impose local option income taxes. The City of Philadelphia was the first local government authorized to levy an income tax in 1938, when it won state approval for the tax. Since that date, Pennsylvania has been joined by nine other states in allowing counties, cities or school districts the ability to impose income taxes:

- In the five states of Indiana, Maryland, Michigan, Ohio and Pennsylvania local income taxes are widely utilized.
- In the five states of Alabama, Delaware, Missouri, New York and Oregon, only a few of the largest cities or counties impose a local income tax.[31]

Arkansas and Georgia also permit local option income taxes, but no such taxes have yet been enacted.[32]

[31] Judith Lohman. "Local Income Taxes," Connecticut General Assembly Office of Legislative Research, November 17, 2005. www.cga.ct.gov/2005/rpt/2005-r-0860.htm.

[32] J. Richard Aronson and Eli Schwartz, editors. *Management Policies in Local Government Finance*. (Washington, D.C., International City/County Management Association, 2004), p. 304.

LOCAL OPTION INCOME TAXES		
State	**Rate for Residents***	**Type**
Alabama		
City of Birmingham	1.0%	Business
Delaware		
City of Wilmington	1.25%	Personal, Business
Indiana		
County Adjusted Gross Income Tax	0.5% to 1.0%	Personal
County Option Income Tax	0.2% to1.0%	Personal
County Economic Development Tax	0.1% to 0.5%	Personal
Municipal Option Income Tax	Maximum of 1%	Personal
Maryland		
County Income Tax	1.25% to 3.2%	Personal, Business
Michigan		
City Income Tax	1% General	Personal, Business
City of Detroit	1% corporations, 2.5% residents	Personal, Business
City of Highland Park	2.0% residents	Personal
Cities of Saginaw, Grand Rapids	1.5% residents	Personal
Missouri		
Cities of Kansas City, St Louis	1.0%	Personal, Business
New York		
New York City	2.55% to 3.2%	Personal
City of Yonkers	5.0%	Personal
Ohio		
Municipalities	2.0% to 2.25% - graduated	Personal, Business
Oregon		
Multnomah County	1.25%	Personal
Pennsylvania		
Municipalities, School Districts	Maximum of 1%; home rule communities can impose a higher rate**	
Philadelphia School District	4.301%	Personal
City of Pittsburgh	1.0%	Personal, Business
Pittsburgh School District	1.875%	Personal, Business

Source: Judith Lohman. "Local Income Taxes," Connecticut General Assembly Office of Legislative Research, November 17, 2005. www.cga.ct.gov/2005/rpt/2005-r-0860.htm.
* Many jurisdictions impose a separate rate for nonresidents.
** The combined municipal and school district income tax cannot exceed 1.0%

Discussion:

In an effort to restrict reliance on property taxes and raise revenues, home rule governments in Illinois increasingly have turned to local option sales taxes as well as fees and charges. However, in northeastern Illinois, sales tax rates are now quite high. With the recent approval of a one percentage point increase in the Cook County home rule sales tax, the composite rate in the City of Chicago is 10.25%, the nation's highest. In suburban northeastern Illinois communities, sales tax rates range from 7.0% to 9.0%.[33] These relatively high rates make it politically difficult for approval of further increases and raise the possibility of seeking other revenue options such as providing for a local option income tax.[34] As the experience of other states shows, local option income taxes could be provided for non-home rule units of governments such as school districts as well as home rule counties or municipalities.

[33] Monica Garcia and Emma Graves Fitzsimmons. "Beating Cook's Sales Tax," Chicago Tribune, March 9, 2008.
[34] The sales tax rate is high in part because it is imposed primarily on goods, not services, thus effectively narrowing the tax base. Municipalities and the Regional Transit Authority do impose a sales tax on food and prescription drugs as well.

Possible Proposals:

1. Permit home rule governments the ability to impose local option income taxes. As noted above, the Illinois General Assembly already possesses the authority to permit home rule income taxes. However, it has chosen not to do so.

2. Permit certain types of non-home rule government such as school districts to impose local option income taxes.

REVENUE CAPABILITIES OF NON-HOME RULE GOVERNMENTS

Article VII - Local Government Section 7. Counties And Municipalities Other than Home Rule Units.

Counties and municipalities which are not home rule units shall have only powers granted to them by law…

Article VII - Local Government Section 8. Powers and Officers of School Districts and Units of Local Government Other than Counties and Municipalities.

Townships, school districts, special districts and units, designated by law as units of local government, which exercise limited governmental powers or powers in respect to limited governmental subjects shall have only powers granted by law.

Discussion:

As noted above, Illinois non-home rule governments may only exercise those powers authorized by the General Assembly and therefore can only access a limited number of revenues. As a result, they do not have a diverse revenue steam and are very reliant on property taxes. This has a twofold effect: 1) arousing continued and strong public opposition to steady increases in property taxes even though the increases are limited by the tax cap; and 2) seriously limiting the ability of these governments to provide for budgetary priorities, especially those expenditures funded through tax capped General or Education Funds. Allowing non-home rule governments, especially school districts, access to a wider variety of revenues could assist them in reducing the property tax burden for local taxpayers and give them the ability to better fund key priorities without state assistance.

Any attempt to grant broader revenue raising powers to local non-home rule governments would raise public concerns about greater tax burden. Therefore, such a requirement might be linked to a guarantee of property tax relief. This could be accomplished by additional limitations on property tax raising ability, such as a freeze, a rate of increase less than the rate or inflation or the assumption of funding by the State government. As half or more of the average property tax bill in Illinois is earmarked for schools, such a proposal could have a direct and long lasting impact on local tax burden.

Another proposal that could provide relief to non-home rule governments would be the abolition of all or some property tax rate limits. Property taxes are levied by fund. Many funds such as the General or Education Fund are rate limited; others such as the Bond and Interest Fund are not.

The premise is that monies should be earmarked to ensure that are spent for designated purposes and to limit the taxing and spending authority of these governments. This often leads to situations in which non-rate limited funds accumulate large surpluses while rate limited funds that pay for operations are strapped for cash. As non-home rule governments' property tax levy increases in tax capped counties are already limited by the tax cap, it may be anachronistic to also impose rate limits. The purpose of limiting spending is already fulfilled. The requirement of fund segregation would be maintained, as it must, to ensure that funds are set aside to pay for obligations such as debt service or pensions are met. But, governments would acquire more flexibility to manage monies based on their needs and requirements.

Possible Proposals:

1. Allow selected non-home rule governments the ability to impose local option income, sales or other taxes. This provision could be linked to property tax relief requirements. Expanding the revenue capacity of local governments by affording them access to a wider range of revenues could help them develop diverse revenue bases and reduce heavy reliance on property taxes. However, expanding revenue possibilities could be an invitation to increasing the tax burden on taxpayers.

2. Abolish property tax rate limits for non-home rule governments. Abolishing tax rate limits could give non-home rule governments greater flexibility in managing their resources. However, elimination of the rate limits could reduce the accountability of these governments; rate limits ensure adherence to legislative fiscal intent in authorizing levies.