New report shows flat income taxes can also redistribute tax burden

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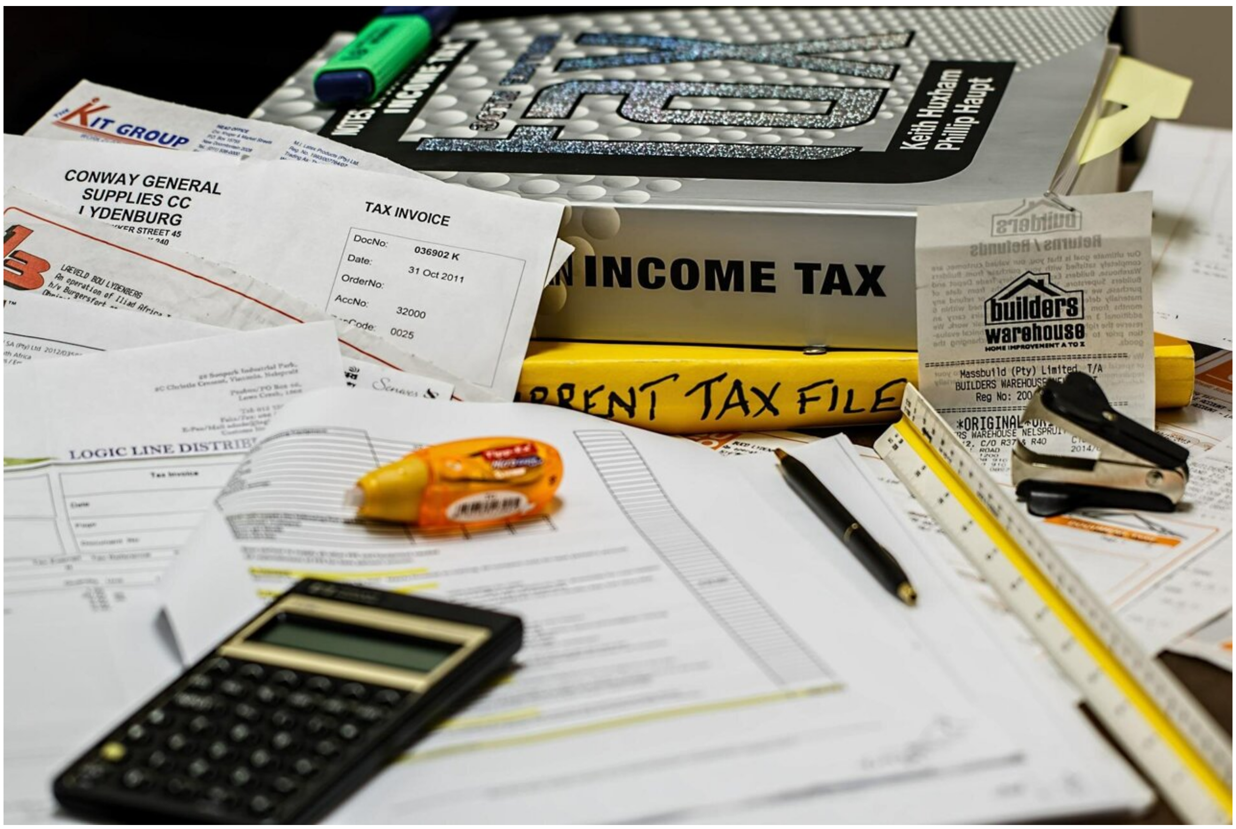

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A new analysis found that achieving a "fair" state income tax system is more complicated than the debate between a flat tax rate and a graduated rate would suggest.

The Policy Spotlight, titled "The Earth isn't Flat, and Neither is Illinois'— or any other state's— Income Tax," discusses the many factors that determine state personal income tax liabilities and demonstrates that graduated tax rates are not the only way to achieve a progressive tax system.

The report is co-published by the University of Illinois Chicago's Government Finance Research Center and the University of Illinois System's Institute of Government and Public Affairs. A research brief, summarizing key takeaways of the report, can be found online.

"Oversimplifying tax-policy choices can lead to symbolic victories that do little to promote fairness," said David Merriman, a co-author of the Policy Spotlight and the James J. Stukel Presidential Professor of Public Administration in the College of Urban Planning and Public Affairs at UIC. "Switching from a flat to a graduated tax-rate system will not automatically promote progressivity, and our research shows that even a flat tax system can allow tax burdens to rise with income."

The authors looked to Illinois to illustrate this point. In 2011, Illinois had one statutory state income tax rate of 5%. However, the share of income that tax filers actually paid varied from below zero to more than 5%. The report found that the actual tax burden:

- Was between 4.5% and 5% for only about 4% of tax filers and was greater than the statutory rate of 5% for about 4.3% of filers.
- Was zero for a small portion of the middle third of tax filers, was between 4% and 5% for about 60% of them and was above 5% for about 3.9% of filers in this group.
- Was similar for tax filers in the middle and top thirds of income distribution, but slightly more tax filers in the top third had an average rate near or above 5%.

The report comes as Illinois and other states consider different plans for expanding their Earned Income Tax Credits, which supplement the earnings of low-wage workers. The authors note that the EITC is an important driver in the variance between rates. Another factor that can make the rates tax filers pay differ from the statutory rate is that states often cap the value of tax exemptions and tax credits. Tax filers may face abrupt shifts in rates when their incomes rise and they hit the cap on a credit or an exemption.

"Fairness in state income tax systems requires a lot of attention to detail," said Merriman, who co-leads IGPA's Fiscal and Economic Working Group and serves as interim dean of the College of Urban Planning and Public Affairs. "We want to make sure that individual taxpayers are not hurt because of relatively arbitrary rules like maximum limits on tax credits or exemption amounts. Our research shows that, even when tax filers follow the letter of the law, very similar taxpayers can sometimes have quite different tax liabilities."

Provided by University of Illinois at Chicago

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