

THE LOSS OF THE CORPORATE PERSONAL PROPERTY TAX AND ITS EFFECT ON  
ILLINOIS SCHOOLS: AN OVERVIEW

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The state of Illinois has not had a statewide property tax since 1932. Governor Henry Horner suspended the state property tax levy during the Depression, leaving the levy and collection of the property tax to local governments. Property taxes, particularly personal property taxes, have been attacked in the past few years as being inequitably assessed and collected. As Joseph Meek, delegate to the Illinois Constitutional Convention of 1970, stated:

This is not a tax system--it is a Pay and Pray System. It is aptly called the Sue and Settle System. It aids the large corporation against the small businessman while tempting both of them to corruption.

In the months just preceding the Constitutional Convention of 1970, the Illinois General Assembly had taken steps to relieve the burden of the majority of the taxpayers by proposing an amendment to the Illinois Constitution of 1870. This proposed amendment eliminated individual personal property taxes. It was in this political setting that the delegates to the Illinois Constitutional Convention of 1970 wrote Article IX, Section 5, which states:

(c) On or before January 1, 1979, the General Assembly by law shall abolish all ad valorem personal property taxes and concurrently therewith and thereafter shall replace all revenue lost by unity of local government and school districts as a result of the abolition of ad valorem personal property taxes subsequent to January 1, 1971. Such revenue shall be replaced by imposing statewide taxes, other than ad valorem taxes on real estate solely on those classes relieved of the burden of paying ad valorem personal property taxes because of the abolition of such taxes subsequent to January 2, 1971. If any taxes imposed for such replacement purposes are taxes on or measured by income, such replacement taxes shall not be considered for the purpose of the limitations of one tax and the ratio of 8 to 5 set forth in Section 3 (a) of this article.

It seemed the wise and prudent political action in 1970 to delay the abolition of the personal property tax for nine years. Now that time period is almost over and the legislature has made seemingly little attempt to deal with the problem of replacing the revenue which will be lost. This study was

one attempt to determine the size and nature of the fiscal reform the legislature must bring about in order to fulfill the requirements of Article IX, Section 5.

Before this could be determined, it was necessary to determine what the intent of the article was. Some issues of interpretation had to be resolved.

Examination of the transcript reveals that there was debate over the definition of "individual," as defined in the Senate Joint Resolution 30 (1969) and the clarifying resolution Senate Joint Resolution 67 (1970), which stated:

Resolved, by the Senate of the Seventy-sixth General Assembly of the State of Illinois, the House of Representatives concurring herein, that, in adopting Senate Joint Resolution No. 30, which submits to the electors of this State a constitutional amendment prohibiting the taxation of personal property by valuation as to individuals, it was the intention of this General Assembly to abolish the ad valorem taxation of personal property owned by a natural person or by two or more natural persons, and that, by the use of the phrase "as to individuals," this General Assembly intended to mean a natural person, or two or more natural persons as joint tenants or tenants in common.

The Supreme Court of the United States has since ruled on this issue in *Lienhausen vs. Lake Shore Auto Parts Co.*, which accepted the clarification of individual as was printed on the ballot:

The amendment would abolish the personal property tax by valuation levied against individuals. It would not affect the same tax levied against corporations and other entities not considered in the law to be individuals. The amendment would achieve this result by adding a new article to the Constitution of 1870, Article IX-A, thus setting aside existing provisions of Article IX, Section 1, that require the taxation by valuation of all forms of property, real and personal or other, owned by individuals or corporations.

Upon remand from the United States Supreme Court, the Illinois Supreme Court issued the following supplemental opinion defining individuals:

The constitutional provision barring the imposition of ad valorem personal property taxes on individuals and the U.S. Supreme Court decision (200-650) upholding that exemption permit the imposition of the tax on personalty owned by: partnerships, limited

partnerships, professional associations, professional service corporations, and fiduciaries. This court originally ruled (200-603) that only natural persons holding property as individuals, as tenants-in-common or as joint tenants were exempt. It was on this basis that the U.S. Supreme Court upheld the exemption. In the case of bank shares, they are exempt, as are other shares of corporate stock, only if they are owned by a natural person or persons.

However, there are many other issues which are still unresolved.

Will the ad valorem personal property tax be abolished as of January 1, 1979?

It is important to note that the drafters of the constitution did not directly abolish the ad valorem personal property tax. Instead, the General Assembly was given a mandate to abolish the ad valorem method of personal property taxation on or before a certain date. As Delegates Witwer, Lyons, Elward, and Davis all noted, there is a well-defined body of law which holds that the courts may not mandate the legislature to do something that the legislature fails to do. Cases which have resulted in the legislature being directed to reapportion itself, by the courts, have weakened this construct somewhat. It appears that there is no direct abolition of the personal property tax in the constitution. The first section of the first sentence in Section 5 (c) does not constitute an abolition, but a mandate. This mandate is a nonself-executing demand, but it is instead a continuing mandate for the legislature. That is, the mandate will stand until some legislature chooses to accept the challenge of the mandate.

Can the General Assembly abolish the tax and not replace the revenue?

The drafters of the constitution did not intend for this to be the case. The debate between Mr. Elward and Mr. Davis indicates that this was clearly considered as a possibility. The Illinois State Supreme Court in 1973 in Elk Grove Engineering v. Korzen determined that this was not a possibility, in the

Court's opinion. The court said:

. . . the General Assembly cannot abolish ad valorem personal property taxes which relieve a class of taxpayers of the burden of the tax without imposing replacement taxes in accordance with the provisions of Section 5 (c).

How will the revenue be replaced?

The drafters were careful not to stipulate any method which must be used, but they attempted to allow the General Assembly as much latitude as possible. The only limitations were that the tax revenue generated by the replacement tax should be sufficient to replace the revenue lost; the tax should not be an ad valorem tax on real estate; the tax should not burden individuals not presently paying the tax; and the tax should be statewide in nature. Delegate McCracken stipulated one tax which might serve as a replacement tax, but (an income surtax) quickly retracted his statements in that area.

How much revenue will be replaced?

The limitation in the constitution is "all revenue lost." This amount could be determined by a number of different methods. One method might be the amount extended, another the amount collected, and still another factor could be the time period. At one point in the debate, there was a proposal that the amount be determined as the amount collected over the past three years, but this method was never agreed upon. So, this remains at the discretion of the Legislature.

When may this abolition take place?

The constitutional mandate says "on or before January 1, 1979." There was some discussion that suggests that this was to be a phased transition but that was not to preclude the possibility of an absolute transition if necessary.

How must the money be replaced to the units of local government and school districts?

The constitution does not say. It does not indicate if the money must be replaced to the exact same unit which lost the revenue, or if it may be replaced to the same type of unit in the state.

Must the tax be collected at the state level?

Again, the constitution does not say. It says only that the taxes must be "statewide taxes." There is no prohibition of a tax being authorized by the state government as a replacement tax, but being levied, collected, and distributed at the state level. Or there could be some combination of the previous alternatives. Further, there is no stipulation that the tax have a statewide rate. That would mean that the rate could vary between taxing districts as long as the revenue generated was adequate.

What is the relation between Section 5 (a) and 5 (c)?

The fact that the broad general powers of the legislature in Section 5 (a) have been limited by Section 5 (c) seems clear. If this were not the case, then the Illinois Supreme Court decision in Elk Grove v. Korzen probably would not have been delivered as it was.

It then became important to determine the dollar amounts which would be lost. This was accomplished in the following manner.

Archival real and personal property equalized assessed valuation data for the years 1946-1974, total taxes locally levied for the years 1946-1973, and educational taxes locally levied for the years 1946-1973 were obtained from the Department of Local Government Affairs. This data was used to project the following: (1) real estate equalized assessed valuation 1975-1979, (2) total taxes locally levied 1974-1979, and (3) educational taxes locally levied 1975-1979. Estimates, based upon the preceding projections, were made of: (1) personal property equalized assessed valuation 1975-1979, (2) total taxes locally levied lost 1974-1979, and (3) educational taxes locally levied lost 1975-1979.

An alternative projection and estimate was prepared for the total educational taxes locally levied lost 1975-1979. Projections were made using the multiple regression technique for data analysis.

Archival state aid data for each school district for the 1974-1975 general state aid actual claim was received from the Illinois Office of Education. The actual claim amount, if the formula were fully funded, for each school district was compared to the estimated claim under each of the following situations: (1) the personal property assessed valuation of the district was removed from the district tax base, (2) the district tax base was adjusted to correspond to an assessment level of 33 and 1/3 percent of the market value, and (3) the personal property assessed valuation was removed and the tax base was adjusted to 33 and 1/3 percent of the market value. The comparisons were made to determine the effects of each of these changes in terms of estimated state and local expenditures per Total Weighted Average Daily Attendance (TWADA) pupil on school districts with similar enrollment characteristics, similar organizational type, fiscal neutrality, and permissible variance. School districts were sorted by enrollment characteristics, using a Spearman Rank Order Correlation to determine the magnitude of the change in the rank order of the districts, in terms of equalized assessed valuation per TWADA pupil, under each of the preceding conditions. School districts were then re-sorted by organizational type, again using the Spearman Rank Order Correlation as a measure of magnitude. Comparisons of the Spearman Rank Order Correlations were made to determine which of the conditions imposed had the greatest effect upon a particular organizational type, or a particular group of districts with similar enrollment characteristics. Effects on permissible variance were measured in each of the cases by the McLoone Index and the coefficient of variation. Effects on fiscal neutrality were measured in each case by the Gini Index and the regression coefficient. The results were as follows:

1. On January 1, 1979, the state should be prepared to replace approximately 680 million dollars of lost revenue to units of local government and school districts if present expenditure trends continue. Of this amount, between 390 million dollars and 470 million dollars must be replaced to the school districts.

2. With the present grant-in-aid formula fully funded, the state would have to increase the state contribution to education from 1.390 billion dollars to 1.570 billion dollars. The local contribution to education would have decreased from 1.457 billion dollars to 1.245 billion dollars. The total dollars to be expended for education would have declined from 2.848 billion dollars to 2.815 billion dollars, for a net loss of 33 million dollars.

3. Statewide, there would be no significant change in ranking of school districts on the basis of assessed valuation per TWADA pupil for FY 1975 because of the loss of the personal property tax. However, there would be considerable effect upon the rankings of individual school districts. The effect of the removal of the personal property assessed valuation is a decrease in permissible variance, and an increase in fiscal neutrality. The only exception is the unit district. The unit districts are so close to fiscal neutrality, the results appear inconclusive.

4. There is a decreased percentage of local contribution in regions 1 through 4, and a greater percentage of state aid. Regions 5 and 6 will have an increase in the percentage of local contribution and a decrease in the percentage of state aid. However, region 6 is the only region which will lose any actual dollars in state aid.

5. If the courts determine that the revenue replacement must be on the basis of dollar-for-dollar replacement, then the number of alternative replacement methods is severely limited. Also, it will cause present inequities in school funding to continue. However, if the courts decide that the revenue



may be replaced on the basis that all dollars lost to units of local government and school districts within the state must be replaced, but not necessarily in the same percentage or amount as was lost from one individual unit of local government or school district, then a method could be utilized which would reduce the present inequities in school funding, which are detailed in Chapter III.

6. School districts which have assessed valuations higher than the state guarantee under the new grant-in-aid formula will not have that portion of lost revenue replaced which is a result of the excess assessed valuation above the state guarantee under the present formula. If the courts determine that there must be a dollar replaced for each dollar lost by an individual school district, then there will need to be some form of save-harmless legislation modification introduced. School districts which have tax rates which are higher than the tax rates needed to qualify for the maximum state aid will also be faced with the same problem of unreplaced revenue which was presented by high assessed valuations, with the same end result.

7. Replacement of the revenue lost to the bond and interest fund must be made through some method other than raising the statutory debt limitation on the fund. To do this would simply shift the replacement tax from a tax on personal property to the ad valorem tax on real estate, in apparent violation of the limitations set forth in the constitution. Therefore, it appears that the replacement revenue must come from some new source, such as the state government, perhaps through the Capital Development Board.

8. To decrease the assessed valuation of the school district is to decrease its debt limitation; to increase the statutory debt limitation after the decrease is to shift taxes from personal property assessed valuation to ad valorem real estate.

9. Since there will be no assessment of personal property after January 1, 1979, it would be impossible to determine if the assessed valuation of the school district changed, due to the gain or loss of personal property. If this is to be accomplished, however, then some method, such as five- or ten-year reassessment of personal property, would need to be implemented to determine exactly the change in assessed valuation.

#### Summary

If the legislature chooses to accept the mandate of the constitution, then it appears there are definite limitations upon the type of replacement tax which the legislature may impose. If the replacement tax fails to meet the specifications set forth by these limitations, then the courts may determine that the replacement taxes are unconstitutional.

Generally speaking, the present grant-in-aid formula will replace most of the revenue lost to school districts. The unreplaced portion, 35 million dollars, or 1.21 percent, will be lost for one of two reasons. If a school district has an operating tax rate higher than the qualifying tax rate, or has assessed valuation per pupil higher than the guaranteed minimum, then the portion of the revenue lost because of these conditions will not be replaced by the present grant-in-aid system. Some school districts, which have large concentrations of personal property assessed valuation, will be severely affected by the removal of the personal property assessed valuation. Patrons of those school districts must determine their priorities, in terms of education services, and be prepared to assume a greater portion of the financial responsibility for the provision of those services unless the state replaces the revenue on a dollar-for-dollar bases, or enacts a save-harmless clause.

Although the revenue to be replaced is substantial, approximately 680 million dollars on January 1, 1979, the collection of this revenue for units of local government and school districts is a much more sensitive issue. Because of the limitations upon the type of replacement taxes which the legislature may impose, the taxes must be both broad-based and selective. Whether an increase in the present corporate income tax is utilized, or whether new taxes such as a tax on partnerships or value added is utilized is immaterial. What is significant is that the legislature should enact revenue legislation which will meet the limitations of the constitution.

Depending upon the interpretation of the constitution by the courts, the allocation of the replacement revenue may be easy or extremely difficult. If the courts hold that the revenue may be distributed on a basis which is equitable and approximates the present distribution of the personal property assessed valuation in the state, then any of our several present allocation methods would appear to be adequate. However, if the courts hold that there must be a dollar-for-dollar replacement of lost revenue, then a whole new revenue distribution system may need to be established.

#### Recommendations

It is recommended that:

1. The legislature through its several committees and commissions continue the study of the effects of Article IX, Section 5 (c);
2. Similar studies to this one be done on other portions of the business, municipal, and educational communities to determine the effects that the abolition will have on them;
3. No changes be made to the present constitution until the effects of those proposed changes be carefully analyzed;

4. Any replacement taxes which are imposed be broad-based, but that they do not impair Illinois competitive advantage with other states in attracting and holding business and industry;

5. The present grant-in-aid system to education be continued, with particular emphases on reducing the permissible variation of expenditures between districts and achieving fiscal neutrality;

6. Legislation be considered which would reduce the regional variations in expenditure per TWADA pupil.