ILLINOIS TAX FACTS
TAXPAYERS' FEDERATION OF ILLINOIS 70 • 6 ■ JUNE 2017

Tax Refunds in Illinois–Another Outlier

By Carol Portman

President of the Taxpayers' Federation of Illinois since January 2013, Carol Portman has been working in the state and local tax arena for over two decades.

For a variety of reasons, taxpayers frequently discover that they have paid more in income tax than was actually due. When that happens, at the federal level and in most states, a refund of the erroneously overpaid tax is the usual recourse. However, when a taxpayer has overpaid *Illinois* taxes, a refund is not necessarily automatic. Unlike other states, Illinois has an additional roadblock limiting a taxpayer's access to its money—the available balance in our refund fund.

What is a Refund Fund, and Why Do We Have One?

Essentially, Illinois' refund fund was put in place to prevent the State from using, or worse yet, playing budgetary games with, taxpayers' money. The cure, however, has proven to be no better than the ill it was intended to address.

Under Illinois' Constitution (Article VIII, §1(b)), the State cannot make payments except as authorized by law. That authorization generally comes in the form of appropriations, either in the budget bills passed each year or in continuing appropriations incorporated into statute.[1]

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

In this issue of *Tax Facts* I write about the Income Tax Refund Fund, a well-intentioned reform idea that has not worked as planned, and which deserves to be revisited. The Refund Fund was created to solve the problem of under-appropriating money to pay income tax refunds. When refunds weren't paid because there was no authority to pay them, taxpayers understandably complained that Illinois was borrowing from them—without their permission—to fund state government.

The law creating the Refund Fund included a mechanism to assure there was enough money in the Refund Fund. A percentage of tax collections (the previous year's refunds paid divided by tax collected) was to be diverted to the Refund Fund throughout the year. That should have assured that there was sufficient money, absent a major tax law or economic change, to pay refunds.

Then the games began. The formula was frequently overridden, leaving mounting backlogs of unpaid refunds and taxpayers once again being forced to lend money to Illinois state government. In a nutshell, under-appropriation of refunds was replaced by underfunding the Refund Fund.

Even when the Refund Fund works as designed one can question the mechanism. Essentially money is built up in the Refund Fund starting in July to pay a crush of refunds that will come due in February through May. Between July and February, when there are lots of other bills due and, particularly today, creditors and vendors waiting to be paid, the money just sits in the Refund Fund.

Wouldn't it be easier for the state to simply take refunds out of current tax collections and return overpayments to taxpayers before it deposits the taxes in state accounts? That's what many other states do and seems like a much simpler solution.

The second article in this issue is an update on assessment uniformity, a piece of the property tax system that gets far less attention than the level of taxation and the accompanying calls for a "property tax freeze." The latest data from the Department of Revenue's sales ratio studies show uniformity improving after deteriorating in the volatile real estate market following the 2008 crash. However, as the data show, there is still plenty of room for further improvement.

In Illinois, the authorization for payment of income tax refunds was originally part of the annual budget process—a specific amount was appropriated each year. This led to frustration when refund appropriations were inadequate and taxpayers had no way to collect the money that was rightfully theirs, until the next fiscal year's budget when (or, worse yet, if) additional funds were appropriated.[2] The Department of Revenue frequently asked for a mid-year supplemental appropriation to cover the remaining refunds due when its original request was insufficient.[3]

Effective January 1, 1989, Illinois established an "Income Tax Refund Fund" as a special fund separate and apart from the State's general funds. A portion of income taxes collected is deposited into the fund. (Illinois Income Tax Act §901(c)). Income tax refunds are to be paid from the fund, and such payments are specifically designated as an "irrevocable and continuing appropriation," meaning no annual budgetary appropriation is necessary. (IITA §901(d)(5))

Here is how the measure was described at the time:

> Less controversial … was fine-tuning done to the system that Illinois uses to pay refunds to taxpayers who have overpaid their income tax. Currently the General Assembly pays those refunds by appropriation. And if, as was the case earlier this year, too little money is appropriated, taxpayers can wait and wait for refunds.

> A pair of identical bills — H.B. 2918 and S.B. 1562, both amendatorily vetoed by the governor to delay the effective date by one year until January 1, 1990 — would create an Income Tax Refund Fund and prevent the state from spending money that belongs to taxpayers. Initially 6 percent of individual income tax receipts and 18 percent of corporate receipts would be diverted to the refund fund. Later diversions would depend on balances and estimates of obligations. The money would be set aside and used to pay the refunds and would not be available for other use, as it is now. The legislation would eliminate, or at least make it harder, for the state to use money owed taxpayers for its own operations.[4]

The two identical bills establishing the Income Tax Refund Fund easily passed the House and Senate, and Governor Thompson's attempt to delay the effective date was overridden. Public Act 85-1414 went into effect on January 1, 1989.

The rationale for creating the fund is clear from the legislative history. A special fund and a continuing appropriation meant that the payment of refunds would not be caught up in the politics of the annual budget process, and the state would no longer be "using money that doesn't belong to us in the first place."[5] Constituent complaints about refund delays were also an issue.[6]

As well-meaning as the creation of the Income Tax Refund Fund was, in practice it has been only marginally more satisfactory than the annual appropriations process. The percentage of tax revenues earmarked for the refund fund (called the "diversion rate") was originally supposed to be based on prior year's experience[7], but has been the subject of near-constant tinkering. Sometimes the default rate calculation has been overridden because the Department of Revenue's refund forecasts indicated a different rate would be appropriate, but it appears sometimes the rate was set artificially low simply to free up funds for other purposes, falling prey to the same old political pressures. **Chart 1 on page 4** lists the historical diversion rates.

During the course of the fiscal year, the fund balance goes up as estimated payments are made and paycheck withholding amounts come in, and then each spring during filing season, the balance drops as refunds are paid. **Chart 2 on page 5** shows the average monthly refund fund balance for the past ten years, demonstrating this rise and fall. Ordinarily, this is a good thing—money is set aside over time so that it is available when the need arises. In the case of tax revenues and refunds, however, this is unnecessary because the greatest need for money to pay refunds is during filing season, the same time when tax revenues are also highest. In other words, cash accumulates in the refund fund when it could be used for other purposes, and cash is generally needed to pay refunds only when the state is flush with cash, so a stockpile isn't necessary.

CHART 1. REFUND FUND DIVERSION RATE

Fiscal Year	Individual	Corporate
1989*		18.00%
1990	6.40	20.10
1991	5.20	24.30
1992	5.80	23.30
1993	5.90	23.00
1994	6.90	17.70
1995	6.60	18.60
1996	6.60	19.10
1997	6.30	20.30
1998	5.80	19.00
1999*	7.10	19.00
2000*	7.10	19.00
2001*	7.10	19.00
2002*	7.60	23.00
2003*	8.00	27.00
2004*	11.70	32.00
2005*	10.00	24.00
2006*	9.75	20.00
2007*	9.75	17.50
2008*	7.75	15.50
2009*	9.75	17.50
2010*	9.75	17.50
2011*	8.75	17.50
2012*	8.75	17.50
2013*	9.75	14.00
2014*	9.50	13.40
2015*	10.00	14.00
2016	9.75	15.14
2017	11.20%	17.25%

*** Years when the legislature set the rate, rather than using the statutory formula**

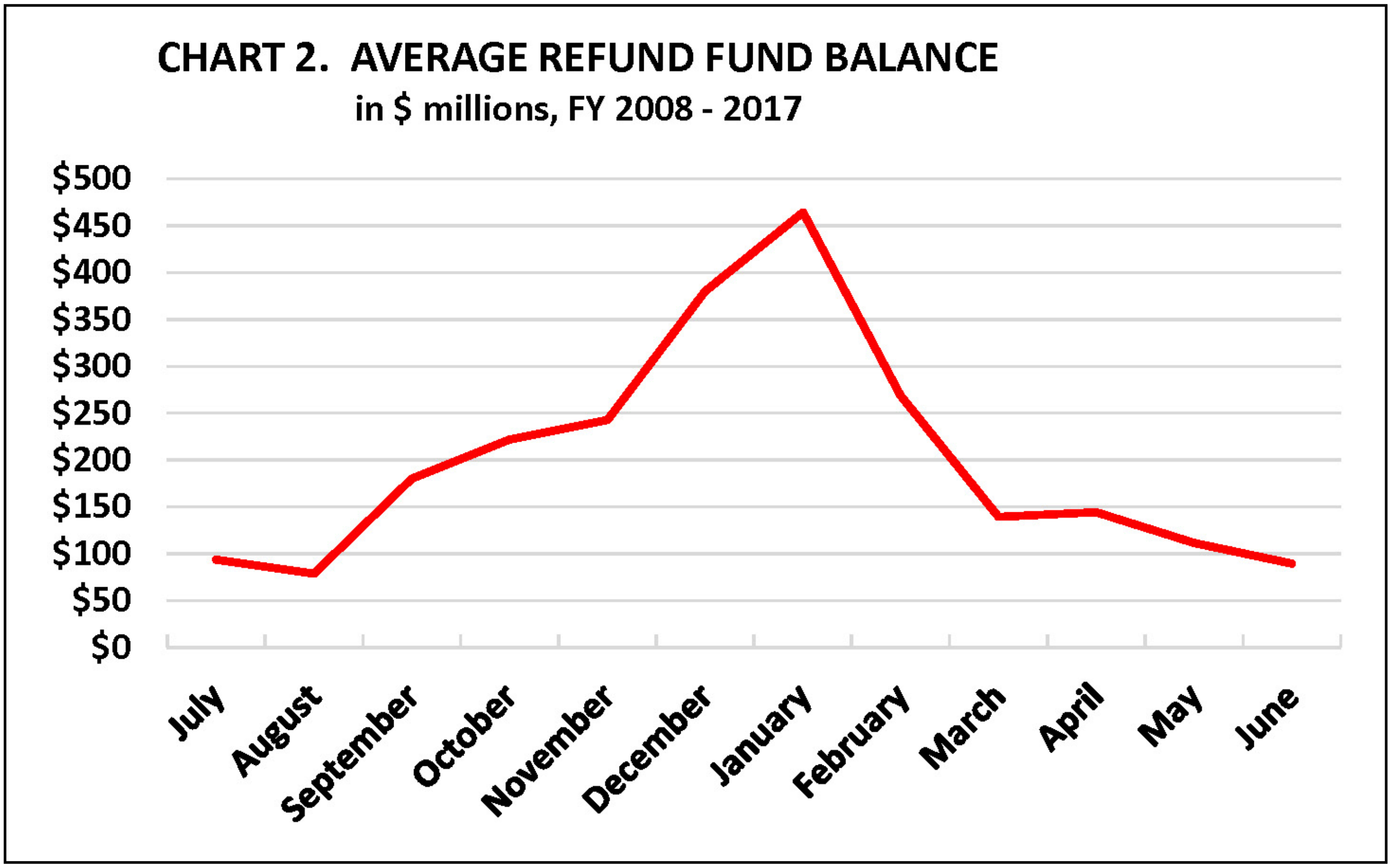
Not surprisingly, changes in tax law, the economy, and the diversion rates have led to additional fluctuations in the overall refund fund, beyond the annual cycle. There have been times when the available balance in the refund fund is inadequate. When this happens, the Department of Revenue is understandably motivated to prioritize individual income tax refund claims. As a result, in periods when the balance is particularly low, the Department delays paying corporate income tax refunds—sometimes for years.[8] **Chart 3 on page 6** shows recent backlogs of unpaid refunds. This underfunding was most acute in fiscal years 2009 – 2011, when the approved but unpaid balance exceeded $600 million.

In the Spring of 2017, the refund fund balance has been low, but not at historic lows. The Department of Revenue has reported that they are paying all refunds, with only a minor delay for corporate refunds, and no delays for individual income tax refunds.[9]

What Do Other States Do?

Most, if not all (we did not conduct an exhaustive review) states have similar constitutional limits on state spending—funds can only be paid out if there is legislative authority to do so (e.g., WI Const. Art VIII §2; NY Const Art VII §7; FL Const Art VII §1(c)). We found no states that meet that requirement in the context of refunding tax overpayments by establishing a "refund fund" that functions in the way Illinois' does.

Instead, in other states, refunds are simply considered an offset against tax collections. The



Department of Revenue or another government agency is statutorily required to issue refunds once they have been approved. Budget predictions and financial statements calculate and report tax revenues as taxes collected net of refunds paid.

Ohio does have a "tax refund fund" but the state treasurer is directed to transfer funds into the fund automatically when the tax commissioner certifies a refund is payable.[10] In other words, the fund is a conduit and not a limiting factor in paying refunds, which are themselves authorized as a continuing appropriation.

Wisconsin's statute regarding appropriations and budget management provides that taxes collected in excess of the amount due are to be refunded.[11] Michigan simply provides that "the department shall certify a refund to the state disbursing authority who shall pay the amount out of the proceeds of the tax.[12] Similarly, New York law requires that any tax overpayments "shall be refunded by the comptroller out of the proceeds of the tax.[13]" All of these are, in essence, continuing appropriations.

Why Does It Matter?

At a time when the State is operating without a budget and has a huge and growing backlog of unpaid bills, it might be easy to believe that taxpayers with refund claims should not be treated any differently from the State's many other creditors. The State's fiscal and budgetary problems, however, will eventually be solved. The refund fund, and the ongoing issues associated with it, will continue, as will the very real risk of returning to the days of refund non-

CHART 3. UNPAID REFUNDS AT FISCAL YEAR-END	
Fiscal Year	**Refunds**
1989	57,600,000
1990	2,700,000
1991	42,900,000
1992	81,200,000
1993	65,100,000
1994	6,200,000
1995	12,700,000
1996	3,400,000
1997	3,000,000
1998	3,400,000
1999	1,300,000
2000	39,700,000
2001	236,200,000
2002	660,100,000
2003	425,400,000
2004	115,600,000
2005	100,000
2006	1,900,000
2007	10,300,000
2008	3,500,000
2009	219,000,000
2010	735,000,000
2011	646,000,000
2012	72,000,000
2013	45,000,000
2014	1,600,000
Source: Institute for Illinois' Fiscal Sustainability at the Civic Federation, blog posts 9/26/2014 and 8/19/2010	

payment. Taxpayers should not be forced to act as lenders to the state and their refunds should not be hijacked to artificially balance a budget—this was the entire point of creating the refund fund in the first place.

There are other reasons to revisit the refund fund concept. As discussed above, it hasn't always worked as intended, and it forces stockpiling of funds for much of the year (diverting them from other uses). And, the whole thing is incredibly complicated and seems to create unintended consequences at every turn (see sidebar, "The Replacement Tax Problem" on page 7).

The country's pre-eminent state and local tax attorney from the 1970s until his death earlier this year, Paul Frankel, was known for much of his career for a six-word mantra: "Don't pay. Don't pay. Don't pay." His advice to clients as they evaluated gray areas of tax law was rooted in the notion that the party with control over disputed funds has the upper hand. This widely-held worldview means states see less in tax revenues paid up-front, because taxpayers are waiting to pay any tax associated with those gray areas until after audits and post-audit disputes are resolved. And if the taxpayer is not audited, the state will never see that revenue. A state that is notorious for not paying even *undisputed* refunds is likely to see an even higher rate of adherents to the "don't pay" philosophy.

In other words, if Illinois doesn't pay refunds, or is constantly teetering on the edge of returning to that scenario, taxpayers will avoid putting themselves into a situation where refunds might be due. This, in turn, means less revenue for the state.

What Should Illinois Do?

There are several alternatives to our current refund fund structure. One obvious option would be for Illinois to return to the days of annual appropriations for refund payments. Unwind the refund fund and hope the issues that arose in the past (inaccurate forecasts—perhaps intentionally so—and underfunding by the General Assembly) do not recur. This approach would reduce (by one) the number of special funds in our state (the proliferation of these funds and the resulting problems have been addressed in previous issues of *Tax Facts* and elsewhere[14]), and there would be no need to accumulate a balance during the year. On the other hand, it seems unrealistic to expect future forecasts to perfectly predict refunds, or future Administrations and General Assemblies to be immune from the lure of reducing tax refund appropriations to fund other worthwhile projects. (See the sidebar "What About Sales Taxes?" on page 8 for a brief description of a more recent occurrence of the same phenomenon.) We would most likely find ourselves in the same predicament that prompted the creation of the refund fund in the first place.

Another option would be to adopt the practice of most other states, and enact a continuing appropriation for tax refunds. The payments could be made out of the General Revenue Funds, or be offset against the fund(s) into which the overpaid tax had originally been deposited. This can get complicated, since certain

The "Replacement Tax" Problem. The Personal Property Tax Replacement Income Tax, more commonly called the Replacement Tax or the PPRT, was created in the 1970s as a tax based on income, applicable to corporations, partnerships, and trusts, at the time the state banned local governments from imposing property tax on personal property. Generally speaking, replacement tax revenues are allocated (after a few diversions) to local governments. The interaction of the PPRT and the Income Tax Refund Fund creates yet another wrinkle to this story. The same diversion rate applicable to corporate income tax applies to PPRT receipts, and PPRT refunds are paid out of the Refund Fund, which as described in the main article is complicated enough, but then IITA §901(d)(3) and (4) mandate an annual true-up process. Local governments did not get money they otherwise would have because it was diverted to the Refund Fund, so if it was *not* used to pay refunds of PPRT, Paragraph (d)(3) provides that the local governments should receive that money. Paragraph (d)(4) deals with the inverse case, when PPRT refunds were paid but not enough was deposited in the refund fund. Even this is fairly straightforward and logical, but nevertheless it became a problem during the period when only individual income tax refunds were being paid (because there wasn't enough money in the Refund Fund, which in turn was because the diversion rates had been set too low). The Refund Fund was at near-zero balance because refunds had been paid to individual taxpayers, yet the law required a transfer to local governments, since PPRT had been diverted into the Refund Fund and no PPRT refunds had been paid.

What About Sales Taxes? Illinois has no similar refund fund in place for our sales taxes—the Retailers' Occupation Tax, Use Tax, Service Occupation Tax and Service Use Tax. A taxpayer that has made an overpayment of tax is issued a "Credit Memorandum" by the Department of Revenue. The taxpayer can use the Credit Memorandum to offset future tax liabilities. If the taxpayer has left the state, changed its business model, or is simply entitled to a large refund that would take a long time to recover through the offset process, the taxpayer can resort to selling its credit to a third party—one of very few instances where Illinois credits are transferable. These transactions typically require the assistance of outside consultants, and are sold at a discount, so as a result the taxpayer receives less than a full recovery. In the past, the legislature has sometimes appropriated small amounts to cover "hardship" refund cases, but those appropriations have stopped in recent years—a more recent example of the problems associated with annually appropriating funds for refund claims. The Illinois Department of Revenue has advocated for the passage of legislation which would establish a very small refund fund for hardship sales tax cases. TFI has supported these efforts, primarily because the cumbersome credit memorandum methodology is no longer needed now that the Department's tax records are maintained electronically and hardship cases in particular deserve a less bureaucratic avenue for relief. Perhaps a better approach would be to abandon both the credit memorandum and refund fund and simply to authorize refunds of all tax types as a continuing appropriation to be netted against current tax collections.

percentages of tax revenues are allocated to various funds, and those amounts have varied over time. Other states have figured this out; Illinois should be able to do so as well. We could adopt Ohio's approach and spread refund payments from local government or other small funds over time.[15] Neither the General Assembly nor the Executive Branch would be able to divert taxpayer funds for other purposes, and there would never again be a backlog of unpaid refund claims, so long as there was money in the state's bank account.

If none of these options turn out to be viable or desirable, at the very least, the diversion rate into the refund fund should be set at an adequate level. Failing to do so undermines the purpose of the fund and repeats the errors of the past, as described at the time:

> The practice that has been indulged in by this government for the past several years, of spending out money that has been paid in erroneously, is nothing short of theft. The Illinois General Assembly and its Executive Branch have been stealing money from taxpayers for other people's business and it's time that the taxpayers have first call on their tax refunds.[16]

ENDNOTES

[1] In recent years, a third category of payment authorization has become increasingly common: the court order. A significant portion of Illinois' state spending for Fiscal Years 2016 and 2017 has been by court orders and consent decrees, rather than in accordance with duly passed and enacted appropriations. The Center for Tax and Budget Accountability estimated that two-thirds of FY2016 spending for current year services was pursuant to consent decrees and court orders. *Illinois General Fund Spending in FY 2016*, CTBA, 10/27/2016, Figure 6.

[2] "Illinois Delaying Income Tax Refunds; State's General Revenue Fund Scrapes Bottom," Chicago Tribune, December 8, 1987.

[3] There are some who believe the annual estimates were deliberately low so that more funds could be appropriated for other purposes.

[4] "Issues revisited: AIDS, tax refunds, etc." *Illinois Issues*, October 1988

[5] Senate floor debate on SB 1562, statement of bill sponsor Senator Dawn Clark Netsch, June 27, 1988, page 133.

[6] See also House floor debate on SB 1562, June 24, 1988, pages 10 – 12 and House floor debate on overriding the veto of HB 2918, November 16, 1988, pages 47 – 53.

[7] The default diversion rate set in statute is equal to refunds approved (whether paid or not) in the prior year, divided by tax collected in that year. IITA §901(c)(1) and (2).

[8] "Illinois out of money for income tax refunds," Peoria Journal Star, June 29, 2011.

[9] It is worth noting that refunds can be delayed for reasons other than a lack of available funding. The Department of Revenue must first approve the refund claim, and ongoing audits and fraud checks, for example, can stop or slow down the refund process.

[10] Ohio Revised Code §5703.052

[11] Wisconsin Statutes Annotated §20.913(1)(b)

[12] MCL §205.30

[13] Tax Law §1086(a)

[14] See, for example, May/June 2012 *Tax Facts,* "Why Ignore Over Half of the Illinois State Budget Picture? Consolidation of General and Special Fund Reporting" by Richard Dye, Nancy Hudspeth and David Merriman.

[15] Another possible downside to this approach could arise if refund claims were unusually high in a particular year, creating fiscal distress for the state. States sometimes use this defense, rather than the merits of a tax position, to oppose taxpayer refunds.

[16] Statement of Representative Pullen, 11/16/1988, pages 50-51.

Illinois Tax Facts

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Assessment Uniformity: Headed Right, Further to Go

By Mike Klemens

Mike Klemens, President of KDM Consulting Inc., does tax policy research for the Taxpayers' Federation of Illinois.

Uniform assessments are the key element in a property tax system which depends on houses of the same value paying the same amount of tax. The latest data from the Department of Revenue shows wide variations in the uniformity of assessments among Illinois counties: McLean County is the most uniform while Alexander County is the least uniform. The encouraging insight in the data is that, aided by stabilization in the real estate market, on average assessment uniformity is improving. For a more complete look at assessment uniformity see: Illinois Assessment Uniformity: Improving Until the Bubble Burst, *Tax Facts 68.4*, July/August 2015.

As part of its equalization process, the Illinois Department of Revenue compares sales prices to assessed value for properties sold in arm's length transactions, to compute equalization factors, more commonly known as multipliers. As a byproduct of that sales ratio study, data collected allow the Department to compute the Coefficient of Dispersion (COD), the standard assessment uniformity measure in the property tax world.

The COD measures how closely, on average, assessment ratios for each property sold fall to the median level of assessment. The smaller the COD, the closer to the median and the more uniform the assessments; a COD of 0 would be perfect. The International Association of Assessing Officials, the professional organization that sets standards for assessments, establishes COD standards between 10 and 25, depending on the composition of property within a taxing district. The CODs produced for each Illinois county for taxes paid this year are shown in **Chart A**. (The year in the Department's sales ratio studies represents the year of the sale, so the 2015 COD's represent 2015 sales used to compute the multiplier for 2016 taxes payable in 2017).

The COD is not entirely dependent on the quality of the work done by assessing officials. A low COD is highly correlated to the homogeneity of property within the taxing district. It is easier to achieve a low COD in taxing districts with large numbers of similar properties than in districts which have a mix of properties or in areas where values are fluctuating.

In 101 counties, the sales ratio study includes all properties. Because of the classification system in Cook County, the Department calculates separate CODs for each class of property and no countywide average COD. The 23.47 Cook County COD in Chart A is for residential property only; Cook's CODs for commercial and industrial

CHART A. 2015 COEFFICIENTS OF DISPERSION (COD) BY COUNTY

COUNTY	COD*	RANK	COUNTY	COD*	RANK
McLean	12.05	1	LaSalle	28.28	52
Kendall	12.86	2	Ford	28.38	53
DuPage	14.27	3	Massac	28.46	54
Champaign	14.96	4	Whiteside	28.77	55
Monroe	15.19	5	Clark	29.42	56
Kane	15.28	6	Stark	29.47	57
Will	15.61	7	Richland	29.64	58
Tazewell	16.31	8	Jasper	30.55	59
Lake	17.16	9	Schuyler	30.90	60
McHenry	17.27	10	Bond	30.95	61
Sangamon	17.56	11	Jackson	31.07	62
Boone	18.27	12	Warren	31.18	63
Effingham	18.45	13	Pulaski	31.51	64
Rock Island	18.49	14	Logan	31.64	65
Moultrie	18.85	15	Hancock	31.90	66
DeKalb	19.28	16	Fulton	31.97	67
Peoria	19.70	17	Mercer	32.49	68
Grundy	19.81	18	Bureau	33.34	69
Morgan	19.86	19	Jefferson	33.43	70
Edgar	19.90	20	Lawrence	33.83	71
Menard	20.06	21	Clay	33.87	72
Woodford	20.30	22	Lee	34.00	73
St Clair	20.54	23	Livingston	34.65	74
Douglas	20.72	24	Marshall	34.94	75
Adams	20.79	25	Calhoun	35.13	76
Coles	20.79	26	Fayette	36.24	77
Pike	21.05	27	Cass	36.91	78
Pope	21.97	28	Wayne	37.14	79
Madison	22.86	29	Perry	37.72	80
Knox	23.02	30	Vermilion	37.77	81
Winnebago	23.17	31	Crawford	38.45	82
DeWitt	23.23	32	Gallatin	38.60	83
Cook	23.47	33	Shelby	38.61	84
Christian	23.89	34	Montgomery	38.91	85
Piatt	23.97	35	Edwards	38.96	86
Scott	24.19	36	Randolph	39.40	87
Cumberland	24.35	37	Mason	39.48	88
Ogle	24.78	38	Wabash	39.92	89
Washington	25.03	39	White	39.99	90
Clinton	25.04	40	Iroquois	41.13	91
Stephenson	25.15	41	Brown	41.17	92
Jersey	25.25	42	Macoupin	41.23	93
Macon	25.31	43	Hamilton	42.60	94
Marion	25.74	44	Saline	42.62	95
Henry	25.80	45	Franklin	45.93	96
Henderson	26.11	46	Hardin	47.11	97
Union	26.43	47	Putnam	48.90	98
McDonough	26.65	48	JoDaviess	49.60	99
Kankakee	26.93	49	Carroll	54.15	100
Williamson	27.04	50	Greene	62.37	101
Johnson	27.60	51	Alexander	74.09	102

* Cook County figures represent Class 2, residential property.
Represents sales in 2015 used for 2016 taxes, payable in 2017
Source: Illinois Department of Revenue

properties were a much less respectable 62.32 and 38.10, respectively.

Generally, statewide average CODs improved through the 1990s, stabilized until they got worse after the real estate crash in 2008, and have begun to improve again more recently. Assessing officials attribute the improvement to computerization and better use of data. **Chart B on page 12** shows the CODs for Cook along with the averages for the five Collar Counties, and the rest of the state, from the period of the boom, through the bust, and into the recovery. It is notable that outside the metropolitan Chicago region, where there was less boom and less bust, CODs have remained relatively stable.

Assessment quality and the COD get little attention from policy makers, who are understandably most attentive to property owners' complaints that "my taxes are too high." Without uniform assessments, however, the property tax cannot be fair. Both the level of taxation and the fairness of that taxation matter.

Taxpayers' Federation of Illinois
430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818

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