

# policy profiles

CENTER FOR GOVERNMENTAL STUDIES Northern Illinois University

## issue: *Tax Caps on Illinois Local Governments: How Well Are They Working?*

by Roger K. Dahlstrom

*Editor's Note:* This is the first in a planned series of *Policy Profiles* that will analyze the fiscal impacts of tax caps for Illinois local governments. Using a school district as an example, this *Profiles* provides an assessment of the impact that tax caps have had in their first 19 years (1991 to 2009) and suggests how they are likely to affect local government operations as the nation's economy recovers from the current recession.

Caps on local government property taxes, used by many Illinois local governments, have limited those governments' ability to raise additional tax revenues through higher property taxes levies. During the period of economic growth in the decades just before and after the turn of the century, local governments appear to have adjusted to tax caps and maintained service levels.

Now, however, economic conditions are much less favorable to local government use of property taxes: economic growth has stalled, property values have been declining and federal and state governments are facing fiscal crises of their own. With money to support local government services withering, reliance on property taxes is likely to increase. What effect tax caps will have on local governments' ability to maintain services in bad economic times is unknown.

This *Policy Profiles* describes how one Illinois local government – Kaneland Community Unit School District #302 (District #302) – has been affected by tax caps since 1992, and offers predictions, based on analytical models, of the effect tax caps may have on the District's ability to sustain its educational services in the years just ahead as the economy struggles to regain its growth momentum.

### Among other findings, the results of this study suggest that:

- Tax caps may have had a much more limiting effect on local government property tax revenues than was intended, and
- Tax caps may have an even more negative effect on property tax revenues during times of recovery from economic recession.

- *Tax caps may have had a more limiting effect on property tax levies than was intended.*
- *Tax caps may have an even more negative effect on property tax revenues during times of recovery from a recession.*
- *While tax caps protect against tax increases in good economic times, they make it more likely that the tax burden on homes and businesses will increase when times are bad.*
- *Tax caps do not protect against rapid increases in the property tax rates when property values are declining.*
- *While new property development helps mitigate the negative effects of tax caps, it does not eliminate those effects.*

**How do tax caps work?**

The Illinois legislature passed the Property Tax Extension Limitation Law (PTELL) in 1991 in response to what some characterized as “skyrocketing property taxes” in the Chicago metropolitan area’s so-called collar counties.

Commonly labeled “tax caps,” these limitations on property tax levies went into effect for most local governmental bodies in Chicago’s five collar counties in 1992. Cook County’s suburban governments were placed under tax caps beginning in the 1995 tax levy year and, in 1996, county boards in all Illinois counties were authorized to allow voters in each county in the state to decide, by referendum, if the PTELL limits should be applied to their county’s local governments. A list of the 39 counties that currently utilize tax caps is provided in **Table 1**.

Under PTELL, tax caps limit the amount of revenue any local government can raise from property taxes on a year-by-year basis to five per cent or the Consumer Price Index (CPI), whichever is less.<sup>1</sup> By law, the tax cap limitations apply to the amount of increase in tax revenue that can be collected, and not to the tax levy rate itself.

The underlying presumption behind tax caps was that real estate values would increase steadily year after year and, indeed, that presumption had been generally accurate since the end of World War II. However, the PTELL legislation did not anticipate the sharp drop in property values that has occurred since the onset of the recession in 2007.

**Table 1: Counties with Tax Caps on Non-Home Rule Local Governments***Counties in Metropolitan Areas*

Boone	DuPage	Kendall	Sangamon
Champaign	Kane	Lake	Will
Cook	Kankakee	McHenry	Winnebago
DeKalb			

*Counties in Rural Areas*

Christian	Jo Daviess	McDonough	Shelby
Coles	Lee	Menard	Stephenson
Cumberland	Livingston	Monroe	Tazewell
Franklin	Logan	Morgan	Union
Greene	Macoupin	Randolph	Washington
Jackson	Marion	Schuyler	Williamson
Jefferson	Massac		

But the sharp drop did occur, and early evidence suggests that the PTELL tax cap limitations might adversely affect the long term revenue raising capability of local governments, particularly during and after economic recessions. The remainder of this *Profiles* draws upon the experience of the Kaneland School District to demonstrate how this could occur.<sup>2</sup>

**Why was the Kaneland School District chosen?**

While each school district is unique, Kaneland Community Unit School District #302 is reasonably typical of Chicago suburban districts that have been experiencing substantial development pressures. Located in western Kane County with a small slice of land in far eastern DeKalb County, the District historically has been a rural school district with a low population density even though it contained several municipalities: Elburn, Kaneville,

Maple Park, Montgomery, North Aurora, Sugar Grove, Virgil, and part of Aurora. However, in the decades just past, these municipalities have experienced significant urban growth and development.

District #302 is thus reasonably typical of school districts in the developing suburban fringe of Metropolitan Chicago. While the majority of its land is still agricultural, the number of students served by the District increased approximately 123 per cent between 1993 and 2009, and the rate of enrollment growth accelerated during the later years of the period (see Graph 3 on page 4). In fact, the rate of enrollment growth continued to increase even after 2000 when the capped tax rate started to fall.

It is likely that District #302 will continue to experience significant residential growth during the course of the next 10 to 20 years notwithstanding the recent downturn in land development activity.

Depending on one's point of view, the District has experienced the best, or the worst, of PTELL's consequences for local governments.

**What happened to District #302 in PTELL's first 19 years?**

The impact of PTELL on District #302 was mixed. The equalized assessed value (EAV) of taxable real estate in the District increased sharply during these years. The EAV of existing property increased an average of 6.1 per cent a year, but new property development in the District increased at an average annual rate of 11.6 per cent over the same period of time.

Despite the tax caps imposed in 1991, which limited the annual increase in property tax revenues to the 2.6 per cent average increase in the consumer price index (CPI), the actual property tax collections in the District increased at an average annual rate of 10 per cent. In part, that was due to successful referenda passed by District voters in 1996 and again in 2005 to increase the maximum school tax levy authorized by law for the District, but a significant amount of the increase was a result of the 11.6 per cent average annual increase in new property added to the tax rolls.

An unanticipated consequence of the 11.6 per cent average annual increase from new property development in the district was that, to comply with the PTELL limits on

tax levies, the District's capped property tax rate drifted downward during the years not affected by referendum tax increases.<sup>3</sup>

**So why might tax caps pose a problem for public schools?**

Despite the encouraging information provided above, tax caps pose both an immediate and a long term threat to public education. Continuing to use District #302 as an example, those problems are primarily the result of three factors:

First, there appears to be a limit to the extent to which the development of new property offsets the tax limits imposed by tax caps. As **Graph 1** indicates, the addition of new property and the increase in the District's total tax levy moved in concert between 1992 and 2001, but a significant divergence began in 2002 and continues

to the present. At first, that divergence was positive, permitting the District's total tax levy to increase at a rate commensurate with the growing need for educational services. But, starting in 2001, the rate of increase in new property to the tax base no longer provided a commensurate increase in the total amount of taxes that could be levied under the tax capped system.<sup>4</sup>

Then, with the onset of the national recession in 2007, conditions turned ominous as tax extensions continued to climb to meet increasing school costs even when the addition of new property dropped precipitously. This emerging trend suggests severe school funding problems could surface in the very near future.

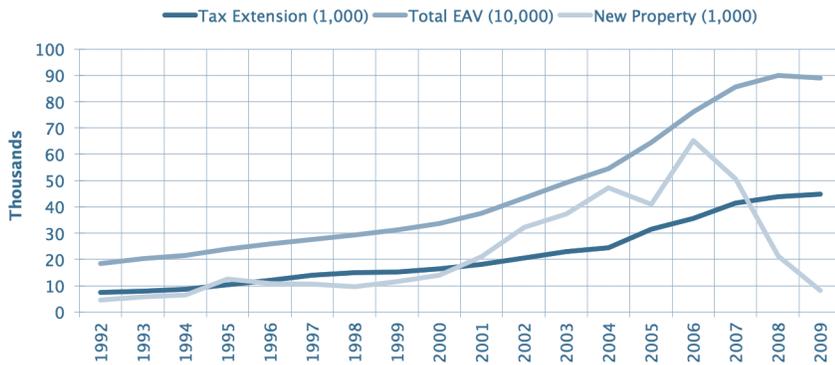
**Graph 1: Kaneland CUSD #302 New Property Tax Extension Trends**



Source: Kaneland CUSD #302

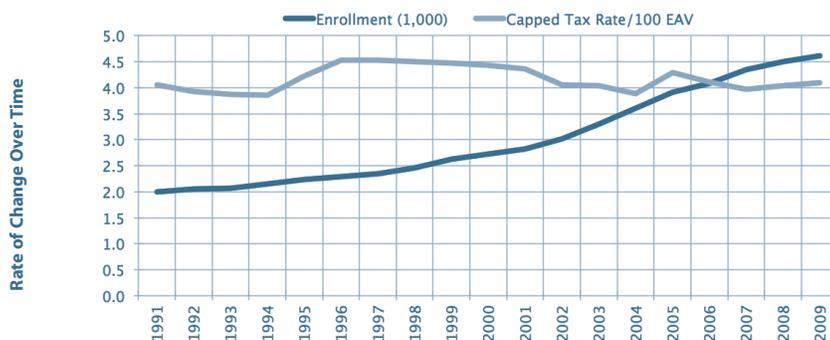
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**Graph 2: Kaneland CUSD #302 EAV/Tax Extension Trends**



Source: Kaneland CUSD #302

**Graph 3: Kaneland CUSD #302 Enrollment/Capped Tax Rate Trends**



Source: Kaneland CUSD #302

That possibility is supported by **Graph 2** which shows that, as the rate at which new property is added to the tax base declines, the rate of growth in equalized assessed valuation also levels off – and might even decline – but the pressure on school costs will likely continue to increase.

Second, as **Graph 3** suggests, it is not at all clear that the tax extension limitation will permit tax rates to rise sufficiently to meet increasing educational costs. The enrollment curve in Graph 3 is consistent with past patterns of increasing educational service costs, especially in areas where new development has been primarily residential. Graph 2 and Graph 3 suggest that enrollment trends continue to rise even though new development falls off. More recent data points indicate that the

capped extension may be falling behind service demands (i.e., may not be producing enough tax revenue to maintain education services at their present level).

Third, changes in public service costs are not accurately, or even adequately, reflected by changes in the consumer price index. This is particularly true for education costs. The labor intensive nature of education and the public's traditional expectation that the public schools must continually improve can combine to drive education costs up at a faster rate than the general increase in the cost of living. In this situation, which is highly likely in the next few years, school tax increases limited by changes in the cost of living index may not enable the schools to levy enough taxes to maintain current levels of education programming.

That is illustrated for District #302 in **Graph 4**. It shows a widening divergence between the CPI and education costs even though, in the 1991-2009 period, District #302 policies regarding student to teacher ratios, average class sizes, and the number and nature of extra-curricular activities did not significantly change.

### What, then, has been District #302's experience with tax caps?

The District's effectiveness in garnering support for proposed referenda, when combined with EAV increases due primarily to new property development, have helped District #302 maintain its level of services despite the existence of the tax caps. The District's experience does suggest that, while new property development helps mitigate the negative effects of tax caps, it does not eliminate those effects.

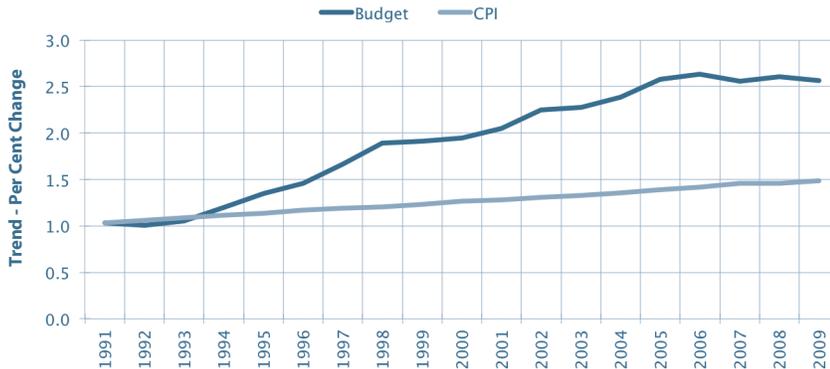
### What does this imply about the use of tax caps?

This question has two parts. The first addresses the net impact that tax caps have had so far. The second speaks to the impact they are likely to have in the foreseeable future. The answer to both questions must be informed by a detailed analysis of past data.

To provide tentative answers to these questions, an analytic model, using District #302 as an example, was designed to predict how the tax caps:

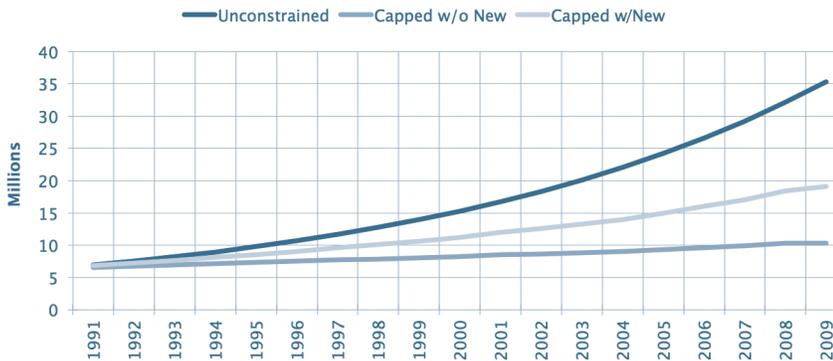
- Have affected District #302. This requires controlling for different variables to isolate more clearly the net effect of the tax caps in the economic climate of the past 19 years.
- Will affect District #302 in the future, based upon an analysis of different forecasts of what the future might look like in the decade ahead.

**Graph 4: Kaneland CUSD #302 Operating Budget and CPI Trends**



Source: Kaneland CUSD #302; U.S. Department of Labor, Bureau of Labor Statistics

**Graph 5: Kaneland CUSD #302 Operating Budget and CPI Trends**



Source: Kaneland CUSD #302

One such detailed analysis of the way tax caps affected District #302 is described in the report, *Tax Caps Implications for Alternative Development Environments*, published by the Northern Illinois University, Center for Governmental Studies (see endnote 2). The remainder of this *Policy Profiles* will summarize the findings presented in that analysis.

**How did the tax caps affect District #302 schools?**

One answer to this question can be made by comparing District #302’s actual tax revenues during the tax capped years 1991 to 2009 to a projection of what the District’s tax revenues might have been if the tax caps had not been put into place. This analysis assumes that the District #302 tax rate had been held constant during those years, an assumption that is consistent with past policies of the District’s School Board. It also disregards the impact of the two tax referenda passed by District voters in 1996 and 2005.

Without tax caps, the projected increase in school taxes, with the tax rate held steady, was only 3.4 per cent (\$11.8 million or \$590,000 per year) larger than the school tax increase actually experienced (capped tax rate plus two referenda increases) over the 19 year period. Thus, in terms of school revenue in a period of rapid property development, increasing property values, and resident commitment to maintaining educational quality, the tax caps appear to have had limited effect.

Graph 5 presents a modeled projection illustrating the relative effects of different conditions. It compares the level of revenues that would have existed without tax caps (unconstrained), the level of revenues that would have come with tax caps but without new property (capped w/o new), and the level of revenues that would result with new property under the tax caps (capped w/new).

The graph suggests that, isolated from other considerations such as successful referenda, tax caps could have had a substantial effect in limiting annual school revenues in District #302.

**What is the likely future impact of tax caps on District #302?**

Had the trends experienced during 2000-2009 remained consistent, the downward pressure on tax rates would have likely continued. School tax levies, under those conditions, would have increased between an estimated \$36.7 million (2009) and \$55.2 million (2020).

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The assumption that those trends would continue on roughly the same trajectory, however, was clearly not the case. The impact of the economic recession, which started in 2007 and plummeted downward in 2008 with the housing and banking crises, was just beginning to be felt by school districts in 2009. But the change in economic conditions did occur, and so trend lines were redrawn to predict how economic decline might affect local government finances when revenue growth was limited by the 1991 tax caps.<sup>5</sup>

As expected, the deteriorating economy caused a decline both in the amount of new development and in the assessed value of existing taxable property within District #302's boundaries. Just as new economic development and rising property values caused a decline in the actual tax rate allowed under the tax cap system, so, too, does a fall-off in new development and falling property values cause an increase in the tax rate to fund the cost of public education. (It should be noted here that some local government costs, such as education and public safety, often continue to increase on a per-unit basis even during periods of economic decline when tax revenues are falling.)

However, the tax rate increases allowed under the tax caps would not be sufficient to offset the negative effects of overall property valuation decreases, and so the total projected property taxes that could be levied by District #302 over the period 2010-2020 would, under the scenario's assumptions, decline from an estimated \$505.4 million without tax caps to an estimated \$486.8 million with the caps.

What this suggests is that, in times of declining property values, the tax cap system could constrain school districts –

and other tax capped local governments – from levying enough tax revenues to cover their increasing service costs. It could mean that schools and other governments might have to cut spending even while raising the maximum amount of tax revenues allowed by the tax caps.<sup>6</sup>

### What is the projected future impact of tax caps?

The rationale behind the tax cap law was that it would limit the taxes that could be collected when property values were increasing. (As explained earlier, tax cap limitations apply to the amount of increase in tax revenue that can be collected, not to the tax levy rate.)

Now that property values have fallen, however, unanticipated consequences have appeared. The tax cap laws still permit an annual increase in the amount of tax levied and collected, and the projections made in the study indicate that increasing tax collections after property values have fallen triggers a rapid increase in the property tax rates.

District #302's experience is instructive. During the first 19 years of rapid growth and development, the tax rate fell from 0.042863 to 0.040899, a decline of 18.6 per cent. After just three years of declines in property values and new development, District #302's tax rate:

- Increased aggressively to 0.048050, a rate increase of 17.5 per cent in just three years, or a rate that was 12 per cent higher than the pre-tax cap rate;
- Under certain conditions, could continue increasing through 2020, to a rate of 0.048283. That rate

would be 12.6 per cent higher than the 1991 pre-tax cap rate and 18.1 per cent higher than the 2007 rate that was levied just before the onset of the recession. Such increases are all allowed by law.

In short, declining property values drive the tax rate up very quickly, and these increases can be of a long duration when the tax cap system is in place.

Adding to the complexity, the increase in the tax rate appears to be insufficient to maintain service standards in the District #302 example. In December of 2010, District #302 officials released budget projections prepared by their financial consultant. Operational deficits were forecast as follows:

2011: \$1.39 million  
 2012: \$1.81 million  
 2013: \$2.99 million  
 2014: \$2.91 million  
 2015: \$2.87 million  
 2016: \$3.41 million

Predictably, budget cuts followed, eliminating some staff positions and student programs.

### What does this mean for the average property owner?

When property valuations are dropping, the tax cap law allows – and, indeed, essentially requires – local governments to raise taxes if such essential services as education, public safety, and health care, are to be maintained. While the tax cap law does provide property owners some protection against tax increases in good times, they may make it more likely that the tax burden on individual homes and businesses will increase, on a relative basis, when the economy is bad.

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## Endnotes

<sup>1</sup> A detailed description of Illinois' tax caps, together with a discussion of the pros and cons of the tax cap system, can be found in the May, 1999, edition of Policy Profiles ([niucgs.org/portfolio/policy\\_profiles/pdf/policy\\_5-99.pdf](http://niucgs.org/portfolio/policy_profiles/pdf/policy_5-99.pdf))

<sup>2</sup> The charts and data presented in this issue are taken from the report, *Tax Caps Implications for Alternative Development Environments*, Center for Governmental Studies, Northern Illinois University, 2010. A copy of the report can be found on the web at [niucgs.org](http://niucgs.org). Data on Kaneland Community School District #302 is taken from District files and reports. Additional data in Graph 5 is taken from the U.S. Department of Labor, Bureau of Statistics (CPI).

<sup>3</sup> It is not clear to what extent, if any, the lower tax rates benefitted individual homeowners, since the reduction in their rates would have been offset to some degree by higher assessed valuations on their homes. Future research will attempt to determine how individual taxpayers were affected by the imposition of the tax cap limitations.

<sup>4</sup> An increase in the tax extension is an increase in the size of the tax base. Detailed research based on modeling suggests that there is a limit to the positive effect new property can exert on the capped tax extension.

<sup>5</sup> The assumptions on which future changes were predicted were formulated in 2010. In retrospect, the assumptions may have understated the depth and length of the economic malaise, but any such miscalculation would have understated the severity of the negative impact of tax caps on school district (and other tax capped local government) revenues in time of recession.

<sup>6</sup> In all of these projections, the rate of increase in education costs was projected to be about the same as it had been. Based on past experience with education costs in recessions, these increases were to be expected and did, in fact, occur since actual cost increases were known for the early years of the recession when the projections were developed.

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## About the Author

**Roger Dahlstrom** is an Assistant Director and Senior Research Associate with the Center for Governmental Studies at Northern Illinois University. His educational background is in urban geography and spatial economics, and he has 38 years of experience in municipal and regional planning. Roger has researched and designed analytical programs for a broad range of subjects including fiscal impact analysis, development impact fees, tax increment financing, site and land capacity modeling, and real estate tax dynamics.

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