Illinois' Proposed Graduated Income Tax: Impacting Jobs and the Economy

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EXECUTIVE SUMMARY

In November, the people of Illinois will be asked to vote on a proposed amendment to the state's Constitution.

If approved by voters, the amendment will give the legislature the authority to establish a graduated income tax system and set the rates at which income will be taxed. Even though the voters have not approved the proposed Constitutional Amendment, the Illinois General Assembly has passed, and the Governor has signed, a bill that would establish the new graduated rates if the amendment passes. Our report describes the economic impact of the proposed tax brackets and initial rates that would comprise the new system, building on the revenue assumptions published by the Governor's office.

BACKGROUND

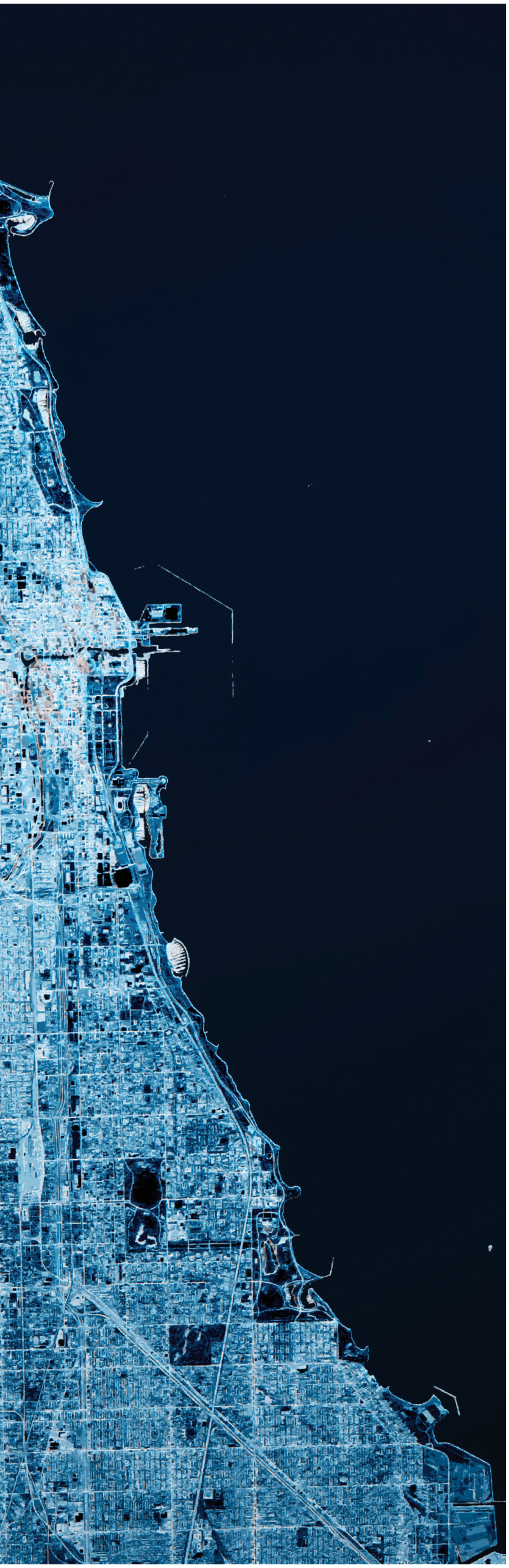
The authors of this study were retained to perform an economic analysis of the proposed Constitutional Amendment and implementing legislation. We requested, and were given, the independence needed to complete an objective analysis of the measures and present our findings. Hence, our findings and conclusions may not necessarily reflect the views of The Illinois Chamber of Commerce.

Illinois' Constitution currently requires all taxpayers, regardless of income, to pay income taxes to the state at the same tax rate. This does not mean that all taxpayers pay the same dollar amount in taxes. A couple or individual reporting twice as much taxable income as another couple or individual generally will pay twice as much in state income taxes. The current rate for individual filers is 4.95%, and the current corporate income tax rate is 7.0%. When combined with the 2.5% property replacement tax, the overall corporate tax rate is 9.5%.

Under the proposed Constitutional Amendment, an individual's or family's tax rate will increase as the taxpayer's income increases. As income increases, the taxpayer moves from one tax bracket to the next, across a total of six income brackets, facing increasing marginal tax rates. This means that an individual reporting twice as much taxable income as another individual will, at the margin, pay more than double the amount of state income taxes, because higher tax brackets carry progressively higher tax rates.

Under the proposed Constitutional Amendment, the individual income tax rate in the highest income bracket will increase from 4.95% to 7.99% (an increase of 61%), while the corporate income tax rate will increase from 9.5% to 10.49% (an increase of 10%), the second highest in the country. The Governor expects to generate $3.5 billion per year in revenue from the tax increases.

When deciding how to vote on the proposed Constitutional Amendment, Illinois voters may want to consider several factors. One factor likely to be considered by many voters is the impact the proposed graduated income tax will have on the Illinois economy. For most Illinois residents, their jobs and income are derived from the success of the Illinois economy.



KEY FINDINGS

Our principal findings regarding the proposal's likely economic effect can be summarized as follows:

1. **No material income tax relief**
   The average annual tax relief per filer in the lower income brackets is small, and might be less than a single family meal at a fast food restaurant for many filers.

2. **Job losses would disproportionately affect women and minorities**
   Women and minorities are likely to be disproportionately affected by the job losses because three of the four sectors of the economy that our economic model indicates will be hardest hit by the tax increase – Hospitals, Restaurants, and Individual and Family Services – tend to employ relatively more workers from these demographic groups. According to the Bureau of Labor Statistics ("BLS"):

   - Hospitals disproportionally employ women (74.9% of jobs in sector vs. 47% of all jobs across all sectors);
   - Restaurants disproportionally employ Hispanic or Latino workers (26.8% vs. 17.6% of all jobs across all sectors); and
   - The Individual and Family Services sector disproportionately employs women (78.3%) and African Americans (20.7% vs. 12.3% of all jobs across all sectors).

3. **Out-migration of thousands of high-income households**
   Some of the job losses will result from reduced spending on food and services arising from an increase in the rate of out-migration by Illinois residents seeking to escape the relatively heavy tax burden that the state imposes on its residents. Based on the most-recent empirical studies by economists, we estimate that increased out-migration will lead to a reduction in household spending by taxpayers in the affected income brackets of up to 0.8%.

4. **Reduction in GDP**
   Approval of the proposed Constitutional Amendment will cause up to a $1.8 billion reduction in the income of Illinois residents annually, as measured by the state's gross domestic product ("GDP").

5. **Higher corporate taxes will be passed on to consumers**
   The corporate tax rate will increase from 9.5% to 10.49% (an increase of 10%), the second highest in the country. Studies show that some portion of revenues arising from an increase in the corporate tax rate ($332 million) would be passed on to suppliers and customers, increasing prices on goods and services, and potentially suppressing worker wages.

CONTEXT IN WHICH THE ECONOMIC IMPACT WILL OCCUR

The job losses and income reductions that would be caused by the adoption of a graduated income tax will take place in a very different Illinois economy than the one that existed when the new tax system was first proposed. In March 2019, when Governor Pritzker unveiled his graduated income tax proposal, the state's unemployment rate was 4.4%, and on its way to 3.4% (November 2019) – the lowest rate reported during the past 44 years. By May 2020, however, the unemployment rate had jumped up to 15.2% -- the highest rate on record. The increase in unemployment was the result of the novel coronavirus and Governor Pritzker' stay-at-home order intended to slow the spread of the virus.

Consequently, rather than eliminate jobs from a relatively strong economy that might have been capable of quickly replacing them, the proposed graduated income tax will now result in job losses that will further weaken an already weak economy.

CAVEAT: OUR ESTIMATE OF THE ECONOMIC IMPACT IS CONSERVATIVE

Our findings on the economic impact of the proposed graduated income tax should be regarded as conservative, for five reasons:

1. Our estimates of out-migration by Illinois residents seeking to escape the higher taxes imposed on them by the graduated income tax – up to 0.8% – are based on out-migration rates that were found to result from smaller tax increases imposed on stronger economies. For example, a recent empirical analysis of out-migration from California following a 19% increase in the marginal tax rate on certain taxpayers in 2012 found that the increase caused 0.8% of the affected taxpayers to leave the state. In contrast, a vote to implement a graduated income tax in Illinois would cause tax increases ranging from 56% to 61% for a large group of taxpayers – increases far larger than those that led to the 0.8% increase in out-migration from California.

2. Even if the higher tax rates that would be imposed by the graduated income tax are ignored, Illinois already ranks near the top in terms of the state tax burden imposed on its residents. It currently has the sixth-highest weighted average sales tax rate (9.08%), the fifth-highest corporate income tax rate, and the second-highest property tax rate. We also find that Illinois has a weak competitive position relative to other states in the Union in many indicators other than tax rates. Together with the higher income taxes, this is likely to worsen the out-migration relative to what has been observed in other states.

3. Further increases in the tax burden on Illinois residents will make it harder for the state to attract entrepreneurs and others who are essential to the creation of new jobs needed to restore the economy to its pre-COVID-19 condition.

4. We have not modeled the effect of raising the corporate income tax rate, from 9.5% to 10.49% because the corporate income tax provides only 4% of state revenues, whereas individual income taxes contribute 21% to state revenues. While the changes to individual income tax rates are likely to have a greater adverse effect on the state's economy than increases in the corporate tax rate, economists have found that state tax rates do influence business behavior. Hence, it is likely that the increase in the corporate tax rate, estimated to cost businesses an additional $332 million, will cause some businesses to go out of business or to leave the state and take the jobs now offered to Illinois residents with them. In addition, under the initial marginal tax rates, the legislature already has the authority to further increase the corporate tax rate to 15.28%, which could result in further job losses and increases in prices.

5. The economic impact is modeled based upon the legislation enacted by the Legislature in 2019. However, states with graduated income tax systems, like California and Connecticut, tend to increase the number of tax brackets and the corresponding tax rates over time. Because the anticipated revenues from the legislation do not come close to offsetting the annual budget deficit and the amount of debt the Illinois government has incurred, it is reasonable to assume that Illinois will similarly increase the income tax rates and brackets in the future. Any tax increase will result in additional job loss and further out-migration.

About the Authors

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Dr. Bill Hamm is an economist with high-level experience in both business and government. An expert on banking and public finance, he has been the executive vice-president/chief operating officer of a AAA-rated $50-billion bank. He has also run a $1.5-billion loan servicing business unit for an S&P 500 company. Prior to entering the private sector, Dr. Hamm headed the non-partisan Legislative Analyst's Office in California, where he earned a nationwide reputation for objectivity, expertise, and credibility on public policy issues ranging from taxation to healthcare.

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Dr. Ariel R. Belasen is a professor of economics at Southern Illinois University Edwardsville. For the past decade he has conducted research in public health, economic development, and anti-corruption endeavors as well as on disaster recovery efforts both domestic and abroad. He has experience as a research analyst for both public and private sector clients.

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Dr. Kevin W. Christensen regularly uses economics to provide insights and answers to public policy and business questions. On public policy matters he has estimated the economic and tax revenue impact of proposed infrastructure investments, tax changes, and regulatory rules. He has advised clients in the oil & gas, pharmaceutical, biotechnology, medical device, banking, automobile finance, wholesale distribution, transportation, consumer packaged goods (CPG), agriculture, building materials, tourism, and gaming industries.

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Dr. Andreas Groehn combines client data with public statistics and data collected through surveys to answer pressing business questions. He regularly conducts economic impact assessments to assess policies and investment projects. Andreas has advised clients in North America, Europe, Africa, Australia and the Middle East out of Brussels, Frankfurt, London and Washington, DC.

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