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Policy Brief #17

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SUBJECT: Analysis of Graduated Income Tax Proposal – Amendment to House Bill 689

This Illinois Economic Policy Institute (ILEPI) Policy Brief is an independent analysis of the potential impact of the graduated income tax Amendment to House Bill 689 by State Representative Lou Lang (D– Skokie). The memorandum discusses the proposal, presents recent data on Illinois' economy and state budget, estimates the tax impact of Representative Lang's amendment, and offers and evaluates alternative tax reform rates. This memorandum has five main conclusions:

1.) Minnesota's top marginal income tax rate is 9.85 percent and its minimum wage is $9.00 per hour, and still its unemployment rate is lower than the comparable rate in Illinois, Iowa, Wisconsin, Indiana, Kentucky, and Missouri.
2.) Despite lower income taxes and reduced state government spending over Fiscal Year 2016, Illinois' unemployment rate has risen and its economic outlook has deteriorated.
3.) Representative Lang's graduated income tax proposal would generate ***$1.46 billion*** in additional state tax revenues and increase total employment in Illinois by over 16,000 jobs, including state government jobs saved by the tax reform. This aligns with, but is slightly more conservative than, projections by the Fiscal Policy Institute at Voices for Illinois Children.
4.) ILEPI's alternative graduated income tax proposal would generate ***$3.63 billion*** in additional state tax revenues and increase total employment in Illinois by nearly 37,000 jobs, including state government jobs saved by the tax reform.
5.) A 5.0-percent flat rate would generate ***$4.00 billion*** in additional state tax revenues but reduce total employment in Illinois by over 54,000 jobs, including state government jobs saved by the retroactive tax increase.

The Proposal: Amendment to House Bill 689

The graduated income tax Amendment to House Bill 689 has been proposed to reduce the state budget deficit while making Illinois' tax code fairer. According the Institute on Taxation and Economic Policy in *Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States (Fifth Edition)*, Illinois currently has the 5th-most "regressive" tax system in the country. As a share of family income, the Bottom 20 Percent of non-elderly taxpayers pay significantly more (13.2 percent) in combined state and local taxes than the Top 1 Percent (4.6 percent) in Illinois (ITEP, 2015).

The bill specifies that Representative Lang's proposed reform would become effective "[i]f and only if an amendment to the Illinois Constitution allowing a graduated income tax is approved by the voters at an election occurring in 2016" (HB689, 2016). Under Representative Lou Lang's proposal, the flat income tax rate of 3.75 percent would be replaced by a graduated income tax structure with four brackets:

1.) ***3.50 percent*** for individuals earning less than $100,000 annually and families earning less than $200,000 annually;
2.) ***3.75 percent*** for individuals earning between $100,000 and $500,000 annually and families earning between $200,000 and $750,000 annually;
3.) ***8.75 percent*** for individuals earning between $500,000 and $1 million annually and families earning between $750,000 and $1.5 million annually; and
4.) ***9.75 percent*** for individuals earning over $1 million annually and families earning over $1.5 million annually.

The Fiscal Policy Center at Voices for Illinois Children, a nonpartisan advocacy organization, has endorsed the proposal. The nonprofit estimates that Representative Lang's proposal would provide a tax cut for 99 percent of income taxpayers while simultaneously raising as much as $1.9 billion. A married couple with an annual income of $55,000 and two children, for example, would experience a $116 income tax cut under the new plan. Representative Lang's proposal would "improve tax fairness and raise revenue to support critical services, all while cutting taxes for the vast majority of Illinois taxpayers" (Miller, 2016).

Many other organizations have recommended a graduated income tax system to put Illinois on sound financial footing. The nonpartisan Civic Federation has proposed a permanent income tax rate of 5.0 percent to address the state's fiscal woes. However, the Civic Federation supports a "modestly graduated rate structure that could lower rates for many taxpayers without affecting revenues" because the flat tax "is burdensome for low income taxpayers" (Civic Federation, 2016). The Institute of Government and Public Affairs at the University of Illinois also lists a graduated income tax structure as "one possible approach to addressing the state's fiscal problems" (Dye et al., 2015). In addition, the bi-partisan Center for Tax and Budget Accountability has claimed that a graduated income tax system in Illinois would "create a fairer tax system while also raising revenue to pay its bills, stimulate the economy, and fund vital public services" (Martire & Lozano, 2012).

The Context: Graduated Income Tax Rates and Recent Experiences in Midwestern States

Four states bordering Illinois have graduated individual income tax systems. In Iowa, individuals earning more than $69,930 in annual income face a top marginal tax rate of 8.98 percent. The top marginal tax rate in Kentucky is 6.0 percent on all earned income over $75,000. Missouri's top income tax rate, 6.0 percent, kicks in at just $9,000. Finally, Wisconsin's individual income tax rate is 7.65 percent for individuals earning more than $244,750 per year and families earning $326,330 per year. Each of these top marginal tax rates is significantly higher than the flat 3.75-percent personal income tax in Illinois (Kaeding, 2016). Illinois' tax code would become more equitable if it adopted a graduated income tax system similar to these four states.

Moreover, the actual experience of Minnesota provides an objective counter to ideological claims that a graduated income tax would harm the economy. On July 1, 2013, Minnesota's top income tax rate was increased from 7.85 percent to 9.85 percent for individuals earning more than $155,650 per year and families earning more than $259,420 per year (*Reuters*, 2013). One state representative said that "[t]he job creators, the big corporations, the small corporations, they will leave" (*The Huffington Post*, 2016). In

addition to a top marginal income tax rate that is higher than the top marginal rate in Illinois and Illinois' bordering states, Minnesota also has a higher minimum wage ($9.00 per hour).

Minnesota's economy is now one of the best in the country. The state ranks fifth in economic growth and first in economic confidence. Meanwhile, the income tax increase helped Minnesota turn a budget deficit into a $1 billion surplus (*The Huffington Post*, 2016). At 3.7 percent, Minnesota's unemployment rate is below the respective unemployment rates of Iowa, Wisconsin, Indiana, Missouri, and Kentucky. Minnesota's unemployment rate is significantly lower than Illinois's 6.5-percent unemployment rate. Claims that increasing taxes on the rich and raising the minimum wage would result in job loss were not only exaggerated – they were wrong (Figure 1).

FIGURE 1: INCOME TAX RATES, MINIMUM WAGES, AND UNEMPLOYMENT RATES IN MIDWESTERN STATES, 2016

State	*Marginal* Income Tax Rate for Individual Earning $50,000 (Link)	*Marginal* Income Tax Rate for Individual Earning $500,000 (Link)	2016 Minimum Wage (Link)	March 2016 Unemployment Rate (Link)
Minnesota	***7.05%***	***9.85%***	***$9.00***	***3.7%***
Iowa	7.92%	8.98%	$7.25	3.8%
Wisconsin	6.27%	7.65%	$7.25	4.5%
Indiana	3.30%	3.30%	$7.25	5.0%
Missouri	6.00%	6.00%	$7.65	4.2%
Kentucky	5.80%	6.00%	$7.25	5.6%
Illinois	***3.75%***	***3.75%***	***$8.25***	***6.5%***

Source(s): Kaeding (2016), WHD (2016), and BLS (2016a).

Finally, Illinois is a case study on the impacts that lower taxes and less government spending have on a state economy. On "January 1, 2015, the individual income tax rate decreased from 5.0 percent to 3.75 percent and the corporate income tax rate moved from 7.0 percent to 5.25 percent" (Nuding, 2016). Simply put, taxes were lowered. The net result was a $3.1 billion drop in individual income tax revenue from Fiscal Year 2015 to Fiscal Year 2016, or a 20.1 percent cut (Figure 2).

In addition, since June 2015, Illinois has operated without a state budget. Accordingly, services have been dramatically cut. Public colleges and universities have gone unfunded, the Monetary Award Program (MAP) grants to help low-income students afford college have been frozen, and programs that service the mentally ill, the disabled, seniors, victims of sexual assault and abuse, victims of substance abuse, and others have been cut (Lloyd, 2016).

In the proposed budget for Fiscal Year 2017, the Office of Management and Budget makes it appear as if total state spending increased in 2016 (Nuding, 2016). Hidden in the document, however, is the assumption that "Estimated 2016" expenditures include spending that has not occurred:

> "The Fiscal Year 2016 Estimated Budget projects that general funds spending will total [$36.1 billion,] an increase of $726 million or 2.1 percent from Fiscal Year 2015 based on current spending patterns and obligations incurred by the state. ***However, that would require passage of appropriations for expenditures in areas that are not now funded***." [Emphasis added.]

The Civic Federation has provided a nonpartisan estimate on obligated spending from the General Fund totaling $34.5 billion in Fiscal Year 2016 (Civic Federation, 2015). Using this estimate, total state spending is revealed to have dropped by about 2.5 percent from Fiscal Year 2015 to Fiscal Year 2016.

The state's unemployment rate has increased by 0.6 percentage points over the year, from 5.9 percent to 6.5 percent (Figure 2). Thus, despite a decrease in taxes and a drop in government spending, the Illinois economy has not improved. Clearly, fixing the budget is far more important than cutting taxes and cutting spending. Budget surpluses improve investor confidence in the State and ensure that funds are available to effectively combat economic downturns.

FIGURE 2: INCOME TAX REVENUES, STATE GOVERNMENT SPENDING, AND UNEMPLOYMENT IN ILLINOIS, 2015-2016

Fiscal Year	Individual Income Tax Revenue (Link)	General Fund Expenditures (Link & Link)	Unemployment Rate in March (Link)
2015	15,433,000,000	35,358,000,000	5.9%
2016	12,335,000,000	34,465,000,000	6.5%
Change	***-20.1%***	***-2.5%***	***+0.6 p.p.***

Source(s): Nuding (2016), Civic Federation (2015), and BLS (2016b).

The Analysis: Representative Lang's Graduated Income Tax Proposal

Representative Lou Lang's Amendment to House Bill 689 would reduce taxes for the vast majority of Illinois taxpayers. As an example, Figure 3 reports tax contributions and effective tax rates for a single individual without children in Illinois under the current 3.75-percent flat tax and the proposed graduated income tax. Estimates are presented by adjusted gross income level. A single, childless individual with an earned income of $20,000 a year would face a 2.90 percent effective income tax rate, lower than the 3.34 percent current rate. Similarly, an individual earning $80,000 annually would contribute 3.16 percent of his or her adjusted gross income in taxes compared to an effective rate of 3.65 percent currently. An individual earning $1 million, however, would experience a 6.18 percent state income tax rate under the proposal, up significantly from the 3.74 percent rate in 2016.

FIGURE 3: ESTIMATED TAXES AND EFFECTIVE RATES FOR SINGLE, CHILDLESS INDIVIDUAL BY PROPOSAL – LANG

Adjusted Gross Income	Current State Income Tax Contributions	Current Effective State Income Tax Rate	Proposed State Income Tax Contributions	Proposed Effective State Income Tax Rate
$20,000	$668	3.34%	$579	2.90%
$40,000	$1,418	3.55%	$1,229	3.07%
$60,000	$2,168	3.61%	$1,879	3.13%
$80,000	$2,918	3.65%	$2,529	3.16%
$100,000	$3,668	3.67%	$3,168	3.17%
$250,000	$9,293	3.72%	$8,793	3.52%
$750,000	$27,043	3.74%	$39,935	5.32%
$1,000,000	$37,418	3.74%	$61,788	6.18%

Source(s): Author's analysis of HB689 (2016).

Figure 4 assesses the entire tax impact through a dynamic market simulation using IMPLAN, the industry-standard for economic impact analysis (IMPLAN, 2015). IMPLAN is an input-output software that estimates the ripple effect, or multiplier, of changes in industry spending or household expenditures. The model is based on Census data and transactions between industries and consumers. Gains and losses in after-tax household income are the "events" that are inputted into the analysis.

A dynamic simulation of Representative Lang's proposal predicts that the graduated income tax would generate ***$1.46 billion*** in additional state tax revenues. The proposal, which ILEPI estimates would be a tax cut for 98.0 percent of taxpayers, would generate approximately $1.48 billion in new personal income tax revenues in a "static" model that holds all else constant. However, the economy is dynamic. The proposal spurs consumer spending among the Bottom 98 Percent but results in less consumption and investment by the Top 2 Percent. The former stimulates employment growth while the latter causes job losses. The initial result of the proposal is a minimal loss of 3,980 jobs in Illinois. This translates into small reductions in income tax revenues, sales tax receipts, corporate income taxes, and motor fuel taxes contributed at the pump. Thus, the overall revenue impact is $1.46 billion in the "dynamic" model – which aligns with, but is more conservative than, projections by the Fiscal Policy Institute at Voices for Illinois' Children.

However, the proposal helps to reduce the deficit, which saves thousands of public sector jobs that are at risk of being eliminated. In fact, the $1.46 billion in new state revenue saves 16,595 state jobs that would otherwise be cut. Because these state government employees spend money in the Illinois economy, the indirect impact of funding these positions is an additional 3,401 jobs saved or created throughout the Illinois economy.

Cumulatively, the proposal would be expected to improve employment by about 16,000 jobs and grow economic activity by about 0.2 percent in Illinois (Figure 4). Representative Lang's graduated income tax proposal would cut taxes for 98.0 percent of Illinois taxpayers, make the tax code fairer, and protect good middle-class jobs in the public sector. Additional revenues of $1.46 billion, however, would only cover 26.1 percent of the $5.60 billion budget deficit that is expected to occur in Fiscal Year 2017 (Civic Federation, 2016). Representative Lang's graduated income tax would have to be combined with spending cuts and other tax increases in order to close the budget deficit.

FIGURE 4: SUMMARY OF ECONOMIC AND TAX IMPACTS OF REP. LANG PROPOSAL, 2017

Impact Item	Lang Proposed Rates: Estimate
Share of Taxpayers with Tax Cut	98.0%
Share of Taxpayers with Tax Hike	2.0%
Static: New Income Tax Revenue	+$1,477,323,000
Dynamic: Income Tax Effect	-$4,351,000
Dynamic: Sales Tax Effect	-$8,280,000
Dynamic: Corporate Tax Effect	-$2,011,000
Dynamic: Motor Fuel Tax Effect	-$345,000
Net State Tax Revenues	***+1,462,336,000***
Direct Employment Effect	-3,980 jobs
State Government Jobs Saved	+16,595 jobs
Indirect Jobs Saved or Created	+3,401 jobs
Net State Employment	***+16,016 jobs***
Gross Domestic Product	***+0.22%***

Source(s): Author's analysis of HB689 (2016) using IMPLAN (2015) and FRED (2016).

The Alternatives: Proposed ILEPI Fair Tax Rates vs. Permanent 5.0-Percent Flat Tax

Some tax policy experts are concerned that the top tax brackets in Representative Lang's proposal are a bit excessive. Don Fullerton, associate director of the Institute of Government and Public Affairs at the University of Illinois, and Kim Rueben, senior fellow at the Tax Policy Center of the Urban Institute and Brookings Institution, note that the rates could be smoothed out (*The Southern Illinoisan*, 2016).

The Illinois Economic Policy Institute (ILEPI) concurs, and proposes the following graduated income tax structure to replace the flat 3.75-percent rate:

1.) ***0.00 percent*** for individuals earning less than $10,000 annually and families earning less than $15,000 annually;
2.) ***3.00 percent*** for individuals earning between $10,000 and $50,000 annually and families earning between $15,000 and $75,000 annually;
3.) ***5.00 percent*** for individuals earning between $50,000 and $100,000 annually and families earning between $75,000 and $150,000 annually; and
4.) ***7.00 percent*** for individuals earning over $100,000 annually and families earning over $150,000 annually.

The proposed ILEPI rates would help the poorest most. All adjusted gross income under $10,000 would be tax-free for individuals and all adjusted gross income under $15,000 would be tax-free for families. With the $2,175 personal exemption credit, a minimum-wage worker would not have to pay personal income taxes on any income below $12,175– which is essentially the federal poverty line for an individual ($11,880). Additionally, a married couple with two children would not contribute any of their take-home earnings towards income taxes until they earn $23,700, or $15,000 plus four $2,175 exemption credits. Note that this is essentially the federal poverty line for a family of four ($24,300) (ASPE, 2016).

The proposed ILEPI rates are also significantly more equitable. Figure 5 reports tax contributions and effective tax rates for a single individual without children in Illinois under the current 3.75-percent flat tax and ILEPI's proposed graduated income tax. Estimates are presented by adjusted gross income level. A single, childless individual with an earned income of $20,000 a year would face an effective income tax rate of just 1.17 percent, lower than the 3.34 percent current rate and the 2.90 percent proposed by Representative Lang.[1] However, an individual earning $80,000 annually would contribute 3.24 percent of his or her adjusted gross income in taxes, which is above the 3.12-percent rate in Representative Lang's structure but below the 3.65-percent rate currently. An individual earning $1 million would pay 6.65 percent under ILEPI's rates, nearly 3 percentage-points higher than his or her current rate.

Figure 6 again assesses the entire tax impact through a dynamic market simulation using IMPLAN. As before, gains and losses in after-tax household income are the "events" that are inputted into the analysis. Figure 6 is different from Figure 4, however, in that it includes a forecast for a retroactive increase in the individual income tax to a permanent 5.0-percent flat rate, as espoused by the Civic Federation (Civic Federation, 2016).

A dynamic simulation of ILEPI's proposed rates predicts that the graduated income tax would generate ***$3.63 billion*** in additional state tax revenues. The proposal, which would be a tax cut for 75.3 percent of

[1] Due to the 0.00 percent tax on income below $10,000 and the $2,175 personal exemption, only $7,825 of the $20,000 total would be subject to the 3.00 percent marginal rate. 3.00 percent of $7,825 is $235, and $235 is 1.17 percent of the $20,000 total.

taxpayers, would generate approximately $3.68 billion in new personal income tax revenues in a "static" model. But in a "dynamic" model, higher taxes for 24.7 percent of taxpayers initially results in 12,981 jobs lost and a decline in state tax revenues of roughly $50 million. Nevertheless, the cumulative impact on state tax revenues is a gain of $3.63 billion.

FIGURE 5: ESTIMATED TAXES AND EFFECTIVE RATES FOR SINGLE, CHILDLESS INDIVIDUAL BY PROPOSAL – ILEPI

Adjusted Gross Income	Current State Income Tax Contributions	Current Effective State Income Tax Rate	Proposed State Income Tax Contributions	Proposed Effective State Income Tax Rate
$20,000	$668	3.34%	$235	1.17%
$40,000	$1,418	3.55%	$835	2.09%
$60,000	$2,168	3.61%	$1,591	2.65%
$80,000	$2,918	3.65%	$2,591	3.24%
$100,000	$3,668	3.67%	$3,548	3.55%
$250,000	$9,293	3.72%	$14,048	5.62%
$750,000	$27,043	3.74%	$49,048	6.54%
$1,000,000	$37,418	3.74%	$66,548	6.65%

Source(s): Author's analysis of a tax reform alternative.

The proposal helps to reduce the deficit, which saves thousands of public sector jobs that are at risk of being eliminated. In fact, the $3.63 billion in new state revenue saves 44,408 state jobs that would otherwise be cut. Because these state government employees spend money in the Illinois economy, the indirect impact of funding these positions is an additional 5,409 jobs saved or created throughout the Illinois economy.

FIGURE 6: SUMMARY OF ECONOMIC AND TAX IMPACTS OF ILEPI PROPOSAL VS. 5.0 PERCENT RATE, 2017

Impact Item	ILEPI Proposed Rates: Estimate	5.0% Permanent Rates: Estimate
Share of Taxpayers with Tax Cut	75.3%	0.0%
Share of Taxpayers with Tax Hike	24.7%	100.0%
Static: New Income Tax Revenue	+$3,677,666,000	+$4,513,436,000
Dynamic: Income Tax Effect	-$14,383,000	-$125,120,000
Dynamic: Sales Tax Effect	-$27,861,000	-$313,463,000
Dynamic: Corporate Tax Effect	-$6,806,000	-$62,214,000
Dynamic: Motor Fuel Tax Effect	-$1,162,000	-$10,458,000
Net State Tax Revenues	***+3,627,454,000***	***+4,002,181,000***
Direct Employment Effect	-12,981 jobs	-110,470 jobs
State Government Jobs Saved	+44,408 jobs	+48,995 jobs
Indirect Jobs Saved or Created	+5,409 jobs	+7,250 jobs
Net State Employment	***+36,836 jobs***	***-54,225 jobs***
Gross Domestic Product	***+0.52%***	***-0.53%***

Source(s): Author's analysis of two tax reform alternatives using IMPLAN (2015) and FRED (2016).

The proposal would thus be expected to improve employment by almost 37,000 jobs and grow economic activity by about 0.5 percent in Illinois (Figure 6). The ILEPI rates make the tax code fairer by effectively eliminating incomes taxes for those in poverty and raising taxes on the rich. In total, approximately 75.3

percent of taxpayers would receive a tax cut under ILEPI's graduated income tax proposal. The $3.63 billion in additional revenues would cover 64.8 percent of the $5.60 billion budget deficit that is expected in Fiscal Year 2017 (Civic Federation, 2016). Therefore, the graduated income tax could be combined with minor spending cuts and small tax or fee increases in order to balance the budget.

Proposed graduated tax rates by both Representative Lang's and the Illinois Economic Policy Institute are preferred to a permanent 5.0-percent flat income tax rate (Figure 6). While a return to the 5.0 percent income tax would be expected to generate the most in net state tax revenues ($4.00 million), it would be a tax hike on every Illinois taxpayer. As a result, consumer demand would decline across all income groups. Because the poor spend a larger share of their income back into the economy, the flat tax hike would harm low-income workers most. The net results would be over 54,000 total jobs lost– even after saving state government jobs– and a 0.5 percent decline in economic activity.

This finding corroborates the Civic Federation's recommendations. Without an amendment to the Illinois Constitution, a 5.0-percent flat income tax may be a necessary sacrifice as part of a package to eliminate the budget deficit. The 5.0-percent flat tax, however, is burdensome for low-income taxpayers and hampers economic activity. A graduated income tax system is more desirable because rates can be lowered for the majority of workers while raising new revenue, balancing the budget, and growing the economy.

Conclusion

This independent analysis of the potential impact of the graduated income tax Amendment to House Bill 689 by State Representative Lou Lang has five main conclusions:

1.) Minnesota's top marginal income tax rate is 9.85 percent and its minimum wage is $9.00 per hour, and still its unemployment rate is lower than the comparable rate in Illinois, Iowa, Wisconsin, Indiana, Kentucky, and Missouri.

2.) Despite lower income taxes and reduced state government spending over Fiscal Year 2016, Illinois' unemployment rate has risen and its economic outlook has deteriorated.

6.) Representative Lang's graduated income tax proposal would generate ***$1.46 billion*** in additional state tax revenues and increase total employment in Illinois by over 16,000 jobs, including state government jobs saved by the tax reform. This aligns with, but is slightly more conservative than, projections by the Fiscal Policy Institute at Voices for Illinois Children.

3.) ILEPI's alternative graduated income tax proposal would generate ***$3.63 billion*** in additional state tax revenues and increase total employment in Illinois by nearly 37,000 jobs, including state government jobs saved by the tax reform.

4.) A 5.0-percent flat rate would generate ***$4.00 billion*** in additional state tax revenues but reduce total employment in Illinois by over 54,000 jobs, including state government jobs saved by the retroactive tax increase.

Lawmakers in Illinois should learn from the experience of neighboring states. A graduated income tax system can make the state's tax code fairer, can fund essential public services and protect middle-class jobs in state government, and can grow the economy. The state should pass a constitutional amendment to implement a graduated income tax structure that works for Illinois.

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