Twelve Things to Know About the “Fair Tax for Illinois”

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Key Findings

- New Illinois Gov. J.B. Pritzker (D) has proposed sweeping changes to Illinois’ tax code, advocating a constitutional amendment to permit a graduated-rate income tax and proposing a new rate and bracket structure.

- Under the proposal, corporate income would be taxed at 10.45 percent, the third-highest rate in the nation, while pass-through business income would be taxed at a top rate of 9.45 percent, the fourth highest such rate nationwide.

- The proposal diverges sharply from ideal—or even typical—income tax structure. It omits inflation indexing (resulting in “bracket creep”), creates a marriage penalty, and includes a recapture provision which subjects the entirety of a taxpayer’s income to the top marginal rate once they reach that bracket.

- The neighboring states of Indiana, Iowa, Kentucky, and Missouri have all cut income taxes in recent years, while Illinois may be headed in the opposite direction.

- The governor’s proposed tax rates are merely notional; should voters permit a graduated-rate income tax, there are compelling reasons to believe that rates may climb even higher, and that more taxpayers would be subjected to higher rates.

- Were the proposal implemented, Illinois is projected to decline from 36th to 48th on the State Business Tax Climate Index, which measures tax structure.
Introduction

The new governor of Illinois, J.B. Pritzker (D), has one campaign behind him, but an even bigger one lies ahead: convincing the legislature—and Illinois voters—to scrap a key constitutional feature of Illinois’ system of taxation.

A provision in the state constitution which prohibits a graduated-rate income tax has long been a source of controversy.¹ In a state where taxes tend to be high, it has also been crucial to keeping one tax (the individual income tax) highly competitive, because there are practical and political limits on just how high a rate can go when it is applied uniformly.

The constitutional amendment Gov. Pritzker is championing would change all that, and under the rates and brackets he has proposed,² would give Illinois some of country’s highest income taxes (individual and corporate), particularly on businesses. That’s of particular concern in a state that has struggled to stem the tide of business departures, as the governor noted in remarks this week, but it’s only one of many issues raised by the proposal.

All told, the governor’s “Fair Tax for Illinois” proposal would result in a 10.45 percent combined rate on corporate income, and a 9.45 percent rate on about half the state’s pass-through income, including the “personal property replacement taxes” the state tacks onto rates (discussed later).

It is important to note that the governor’s proposed rates and brackets will likely be separate from the actual constitutional amendment on which the legislature and, ultimately, the people, will vote. They are notional—a sense of where he is headed. Although an amendment could, theoretically, enshrine a set of rates and brackets in the constitution, or cap the top rate, it is more likely that an amendment will simply lift the prohibition on a graduated-rate income tax, leaving this and subsequent legislatures to adopt rates of their choosing. (A joint resolution proposing a constitutional amendment has already been introduced, but it does not appear to be entirely consistent with Pritzker’s plan.)

Under Gov. Pritzker's proposal, however, the current 4.95 percent flat individual income tax would be transformed into a six-rate tax, with rates ranging from 4.75 to 7.95 percent. A recapture provision means that filers with income in the top bracket will have their entire income, not just their marginal income, subject to the top rate of 7.95 percent. Meanwhile, the base corporate rate would increase from 7 to 7.95 percent (10.45 percent counting the personal property replacement tax), in a misguided—and miscalculated—effort to match the new top rate on individual income.

The plan also includes an increase in the value of the property tax credit, from 5 to 6 percent of the taxes paid on one's primary residence, and a new $100 per child tax credit, which phases out beginning at $40,000 in income ($60,000 for two-income families). The following table shows the proposed rates and brackets.

1 Ill. Const. art. ix, § 3, cl. a.
Many things could be said about this proposal, but here are twelve points that should be part of any consideration.

1. The proposal would create some of the highest rates in the country.

When Illinois lawmakers repealed the state’s taxes on tangible personal property forty years ago, they paid for the repeal by creating a second set of taxes on both pass-through and corporate income, confusingly termed “personal property replacement taxes” (PPRTs). The name references the tax they replaced rather than the nature of the taxes themselves, which are nothing more than additional income tax levies of 2.5 percent on corporate income and 1.5 percent on the income of pass-through businesses, with revenue devoted to local government. The income of pass-through businesses (S Corps, partnerships, LLCs, and sole proprietorships) “passes through” to their owners’ individual income tax returns (hence the name). Including these taxes, the top rate on pass-through businesses would be 9.45 percent and the new rate on corporate income would be 10.45 percent.

This would represent the third-highest corporate rate in the country, after Iowa (12 percent) and New Jersey (11.5 percent), and Iowa is scheduled to reduce its top corporate rate to 9.8 percent in a few years. It also represents the fourth-highest rate on pass-through income nationwide, after California (13.3 percent), Oregon (9.9 percent), and Minnesota (9.85 percent). The 7.95 percent rate on non-business income would be the eighth-highest state rate in the country.

2. Illinois’ neighbors are making their tax rates more competitive, not less.

If Illinois were to raise its rates, it would be moving in the opposite direction of its neighbors. Indiana has reduced its top corporate income tax rate from 8 to 5.75 percent and is on track to bring it down to 4.9 percent in a few years, while its individual income tax rate has gone from a flat 3.4 percent to 3.23 percent over five years. Policymakers in Indiana have consciously positioned themselves as a more competitive alternative to Illinois, and they aren’t alone.

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In Missouri, a set of bills in 2018 reduced the top income tax rate from 5.9 to 5.5 percent, with a further phasedown to 5.1 percent in the works, while the corporate rate is set to fall from 6.5 to 4 percent in 2020. Meanwhile in Iowa, a package of reforms adopted last year will ultimately bring the top individual income tax rate to 6.5 percent (from 8.98 percent) and the corporate rate to 9.8 percent (from 12 percent), and Kentucky just replaced its graduated-rate individual and corporate income taxes with single-rate taxes of 5 percent. Even in Minnesota, legislators are contemplating tax cuts to offset additional revenue from tax conformity. In short, Illinois would be raising its tax rates at a time when its neighbors are headed in the opposite direction.

3. These higher taxes would have a significant impact on Illinois businesses.

While $1 million is undoubtedly a lot of money, over half of all pass-through business income is reported on returns with more than $1 million in business income alone (to say nothing of other income sources), and almost 72 percent comes from returns of $500,000 or higher. Under the Pritzker proposal, taxes would be higher on all income above $250,000—which accounts for the overwhelming majority of net business income from pass-throughs in Illinois. While the Internal Revenue Service does not maintain data using a $250,000 inflection point, we know that more than 93 percent of all pass-through income is on returns claiming more than $200,000 in pass-through income. (See table below.)

In other words, while those paying these higher taxes may be well-to-do, the proposal represents a significant new tax on Illinois employers. While not all pass-through businesses are small businesses, it’s worth noting that small businesses are responsible for 46.4 percent of Illinois employment. In a state already suffering from an outmigration of businesses and high earners, a tax increase of this size could do real damage.

### TABLE 2.
Pass-Through Businesses by AGI Range

<table>
<thead>
<tr>
<th>AGI Range</th>
<th>Number of Businesses</th>
<th>Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 – $24,999</td>
<td>54,050</td>
<td>(1,891,760)</td>
</tr>
<tr>
<td>$25,000 – $99,999</td>
<td>130,200</td>
<td>$1,384,107</td>
</tr>
<tr>
<td>$100,000 – $199,999</td>
<td>98,230</td>
<td>$2,215,954</td>
</tr>
<tr>
<td>$200,000 – $499,999</td>
<td>71,000</td>
<td>$5,289,485</td>
</tr>
<tr>
<td>$500,000 – $999,999</td>
<td>21,720</td>
<td>$5,064,312</td>
</tr>
<tr>
<td>$1,000,000 +</td>
<td>14,870</td>
<td>$12,845,328</td>
</tr>
</tbody>
</table>

Note: In aggregate, businesses with less than $25,000 in AGI post negative income. Sources: IRS Statistics of Income; Tax Foundation calculations.
Illinois ranked 46th in the nation in private sector job growth in 2018.\textsuperscript{10} Policymakers should be exceedingly careful about adopting policies that make it harder to do business in the state.

4. The cost of high rates has never been higher.

With the new $10,000 cap on the state and local tax (SALT) deduction, high earners in high tax states no longer receive a generous federal tax subsidy to offset their state and local tax liability. Under the old law where state income taxes were deductible on federal returns, a rate of 9.45 percent (on pass-through business income) or 7.95 percent (on other income) would reduce federal tax liability to the point that net amount paid on the marginal dollar of income was really 5.71 or 4.80 percent respectively. Under the new law, high earners no longer have the dubious luxury of enjoying the benefits of a high service state while exporting a significant share of their tax burden to non-itemizers or taxpayers in other states. That represents good policy, but it also means that all Illinois taxpayers will feel the brunt of any substantial rate increase, with all that entails. Such high rates could accelerate migration out of Illinois, which is already a major concern.

It’s a concern, in fact, that the governor acknowledged in his press conference, albeit in an effort to dispute it. “Now, there are those who want to scare people by claiming that this proposal will cause residents and businesses to flee Illinois,” said Pritzker. “They couldn't be more wrong. They ignore the fact that people and businesses are fleeing our state now under our current regressive tax system, yet states with fair tax systems on average grow faster and create more jobs than Illinois.”\textsuperscript{11}

This is a curious statement. Individuals and businesses are already fleeing Illinois. Higher taxes aren’t going to turn things around, especially if the tax increase does nothing to address Illinois’ unpaid bills, pension debt, or other fiscal challenges.

5. Business rate parity makes little sense.

There is no real reason why corporate and individual income tax rates should be aligned absent a much broader, structural integration of business entity types, since they are not meaningfully comparable. While many small businesses pay through the individual income tax because they are organized as pass-through entities, traditional C corporations are double-taxed, paying taxes at both the entity level and again at the ownership level, so an attempt to keep the corporate rate aligned with the top individual rate only exacerbates an existing disparity. The PPRT on corporate income, moreover, is one percentage point higher than the PPRT on pass-through income, leading to a higher combined rate on corporate (10.45 percent) than pass-through (9.45 percent) income. Furthermore, documents issued by the Pritzker administration indicate that the corporate rate would remain flat—albeit at a much higher rate—so this does not, in fact, represent a true attempt to align the rates.


6. The new rates include a highly unusual “recapture” provision.

Tax rates are typically marginal, which is to say that they are imposed on marginal income. For instance, under the governor’s proposal, the first $10,000 in taxable income would be taxed at a rate of 4.7 percent, and someone earning $11,000 would only pay the higher rate of 4.9 percent on the additional $1,000, not the whole $11,000. According to handouts outlining Gov. Pritzker’s proposal, however, “[o]nce income reaches $1.0 million, entire income is taxed at 7.95 [percent] rate” (emphasis in original). In other words, the entire benefit of the lower rates on income below $1 million (worth $8,565) disappears for filers with income above that threshold, and their top marginal rate is converted into a flat rate of 7.95 percent.

This is highly unusual. Similar rate recapture provisions exist in only three other states: Connecticut, Nebraska, and New York. Additionally, Arkansas has different tax schedules for different income classes, such that people with higher incomes still face a graduated rate schedule, but a different schedule than one that a middle- or low-income filer would face. Under the federal income tax, and the income tax rate schedules as they exist in all other states, rates are imposed on marginal income, with no recapture provision.

This creates a significant tax cliff, where a person making $1,000,000 pays $70,935 in taxes, while someone earning one dollar more pays $79,500, a difference of $8,565 on a single dollar of income.

Pritzker himself has not endorsed any particular language for a constitutional amendment. The joint resolution that has been introduced thus far has several elements that may be in tension or even at odds with his proposals, including a requirement that there be “one tax” on both individual and corporate income, which would seem to require that the corporate income tax include the entire rate schedule, and not maintain its current single-rate form. It is also not entirely clear that the proposed constitutional amendment even permits a recapture provision, though it does not expressly disallow it. The state constitution currently requires that “[a] tax on or measured by income shall be at a non-graduated rate.” Under SJRCA 1, the tax “may be a fair tax where lower rates apply to lower income levels and higher rates apply to higher income levels”—a description that is not wholly aligned with how a recapture provision would work. It is entirely possible, however, that the language of the joint resolution will be amended to match Pritzker’s proposal.

7. The proposal creates a significant marriage penalty.

A marriage penalty exists whenever two earners owe more tax filing jointly than they would if they filed separately. The penalty can emerge when any part of the tax code—brackets, deductions, or exemptions—do not increase for joint filers, but bracket widths under a graduated-rate income tax are particularly important. Many states double their bracket widths for married couples to avoid the penalty, but the Illinois proposal envisions the same brackets for single and joint filers.
Imagine a two-earner household where both partners make $100,000 in taxable income. If taxed separately under the proposed rates, they would both owe $4,885, for a combined tax bill of $9,770—each having their first $10,000 taxed at 4.75 percent and their next $90,000 at 4.9 percent. But as a married couple filing jointly, the first dollar of the second earner’s income is taxed at 4.95 percent (the rate for income above $100,000). They would face a marriage penalty, small in their case, but much larger as earners get into higher brackets.

One might be tempted to say that we need not be concerned about a modest marriage penalty on dual-income professionals, or a higher penalty on wealthier taxpayers, but bad policy like this is not easily reversed, and there is no guarantee that the rate structure will remain the same forever. If a marriage penalty is accepted from the outset, it may hit far more families down the road, the next time Illinois faces a revenue shortfall.

8. Tax burdens will rise due to “bracket creep.”

Within a graduated rate structure, inflation can impose a hidden tax, increasing the taxpayer’s liability as a greater share of their income is taxed even if that income has not increased in real terms, since bracket kick-in thresholds are fixed. To avoid this “bracket creep,” most states with graduated-rate structures index bracket widths and other features of the income tax to inflation. Pritzker’s proposal gives no indication of this, meaning that over time, taxpayers will pay an increasing amount of taxes as a percentage of income—even if their income has not increased in real terms.

9. There is no guarantee that rates will not rise in the future.

Pritzker’s rate proposal is just that—a proposal. If the legislature and voters grant approval for a graduated-rate income tax, nothing prevents the legislature from adopting higher taxes than those proposed now, or a future legislature from raising rates. Even under a single-rate tax, rates have risen twice in the past eight years (from 3 percent to the current 4.95 percent rate), and a graduated-rate income tax would make future rate increases much easier. The governor implicitly acknowledged this when he dismissed the alternative of a 5.95 percent flat tax.15 When most or all taxpayers share in a tax increase, there is substantial political pressure to balance revenue needs with tax competitiveness. The ability to single out select taxpayers for higher rates—which will also fall on many small businesses—would make future tax increases easier in a state where lawmakers have already demonstrated a willingness to countenance unusually high rates.

Even higher taxes (as high as 11.25 percent on small businesses) have been contemplated in Illinois in recent years, as part of prior graduated-rate income tax proposals. Such rates would be unthinkable in a single-rate system but could easily reemerge if the single-rate requirement were repealed.

10. The numbers do not add up.

This proposal is estimated to increase revenues by $3.4 billion—but not immediately. The $3.4 billion figure appears to be the projection for 2021, the first possible year in which these new taxes could be in place. It’s also closely aligned with the current structural deficit as estimated by the governor’s office. Gov. Pritzker says that the alternative to these tax increases is significant cuts to discretionary spending, which he seeks to avoid, but there is no way that the state can start collecting new revenue under this proposal until the 2021 tax year. Illinois has a tradition of not paying its bills, but this proposal will not help in the short-term, so there is every reason to believe that the structural deficit could exceed $3.4 billion by the time it might conceivably help. The mountain of unpaid bills would presumably be higher, too.¹⁶

That is not an argument for doing nothing, but it does mean that other steps would have to be taken as well, and it also means that all of the new revenue—and then some—would presumably pay for existing government programs. The governor campaigned on increasing school funding, improving infrastructure, expanding social services, and reducing pension debt, and none of those things would be covered by the proposed tax increases. That may be a compelling reason to believe that these rates, as high as they are, will not be the last increases should voters approve a graduated-rate income tax. If that is the case, however, eventually rates will have to rise on middle class families, as there is only so much additional revenue at the top. The governor’s nonbinding rate schedule avoids a tax increase for most of these filers, but how long will that last?

11. The proposal eliminates the best feature of Illinois’ tax code.

The state’s relatively low single-rate individual income tax has historically been one of the few saving graces in a state with otherwise high and economically inefficient taxes. High taxes on income are generally among the least desirable taxes because they discourage wealth creation. A comprehensive review of international econometric tax studies found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The literature on graduated-rate income taxes is particularly unfavorable, with substantial evidence that higher marginal tax rates reduce gross state product growth even after adjusting for overall state tax burdens.¹⁷

Plenty of states with graduated-rate income taxes have better tax codes than Illinois overall, but Illinois policymakers have shown little ability to keep taxes or spending in check, and tax burdens are high throughout the rest of the system. Illinois has the 11th highest state and local tax collections per capita, at $5,654,¹⁸ despite a relatively competitive, flat income tax. Absent the existing constitutional constraints, Illinoisans have every reason to fear that their income tax burdens will continue to rise. A child tax credit, or an expansion of the property tax credit that provides less than $50 in tax relief for the median homeowner, may come to seem like a very small inducement for the income tax burdens to come.

12. Illinois’ business competitiveness will decline.

Every year, the Tax Foundation publishes a new edition of the *State Business Tax Climate Index*, a measure of state tax structure. Illinois currently ranks 36th overall, with its competitive income tax balancing out poor tax structure elsewhere.\(^\text{19}\) If, however, the state were to adopt the graduated rate structure Pritzker proposes, with top rates of 9.45 percent on pass-through income and 10.45 percent on corporate income, while creating a marriage penalty and forgoing inflation indexing, the state’s overall rank would plummet from 36th to 48th, ahead of only California and New Jersey.

<table>
<thead>
<tr>
<th>TABLE 3.</th>
<th>Current and Projected Index Rankings</th>
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<tbody>
<tr>
<td></td>
<td>Current</td>
</tr>
<tr>
<td>Overall</td>
<td>36</td>
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<tr>
<td>Corporate</td>
<td>39</td>
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<tr>
<td>Individual</td>
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<tr>
<td>Sales</td>
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<td>Property</td>
<td>45</td>
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<tr>
<td>U.I.</td>
<td>42</td>
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</tbody>
</table>

Source: Tax Foundation calculations

States should care about their *Index* ranking because it is measuring something real and economically meaningful—the competitiveness, or lack thereof, of the state’s overall tax structure. Were Pritzker’s proposal adopted, Illinois would trail its peers in just about every aspect of its tax code. If businesses and individuals are leaving the state now, these policies can only make the problem worse.