TAX FOUNDATION
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FISCAL FACT
Jan. 2014
No. 411

Illinois Considers Further Income Tax Increases as Temporary Tax Nears Expiration

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Key Findings

- Illinois' State Business Tax Climate Index score could fall to 44th, from 31st currently, if the proposed progressive income taxes are passed, which indicates a tax climate less supportive of economic growth
- Illinois already fell from 17th over the last few years with several rounds of tax increases, which did not succeed in alleviating Illinois' financial situation or improve the economy
- Higher and more progressive income taxes generally contribute to worsening economic performance

Illinois significantly raised taxes in 2011 in an attempt to address its $8.5 billion backlog of unpaid bills and other financial difficulties. The state raised its flat individual income tax from 3 percent to 5 percent and increased the corporate income tax from 7.3 percent to 9.5 percent.[1] The 2011 tax increases have generated between $7 billion and $8 billion in added revenue each year.[2]

In 2015, the tax increases are scheduled to partially sunset, with the individual income tax dropping from 5 percent to 3.75 percent and the corporate income tax dropping from 9.5 percent to 7.75 percent (see Table 1). In 2025, the individual income tax is scheduled to drop further to 3.25 percent and the corporate income tax to 7.3 percent.

Table 1: Illinois Tax Rates

	Pre-2011	2011 to 2014	2015 to 2024	2025 and after
Individual Income Tax Rate	3.0%	5.0%	3.75%	3.25%
Corporate Income Tax Rate	7.3%	9.5%	7.75%	7.3%

Source: 35 ILCS 5/201(b); 35 ILCS 5/201.5; 35 ILCS 5/201(d).

1 See Kail Padgitt & Joseph Henchman, *Illinois Approves Sharp Income Tax Increase, Fourth-Highest Corporate Tax Rate*, Tax Foundation Fiscal Fact No. 256 (Jan. 13, 2011), http://taxfoundation.org/article/illinois-approves-sharp-income-tax-increase-fourth-highest-corporate-tax-rate. Illinois' corporate income tax consists of a net income tax (currently 7 percent) and a property replacement tax imposed on corporate income (currently 2.5 percent). Reference sources that cite Illinois' corporate income tax, including the Illinois Department of Revenue, report it as a combined tax.

2 Commission on Government Forecasting and Accountability, *Budget Summary Fiscal Year 2014*.

Despite the added revenue from the 2011 tax increases, the state's backlog of unpaid bills grew to $9 billion by 2013 before dropping at the end of the year to $7.6 billion.[3] Additionally, interest payments have more than doubled and the state's credit and economic outlook remains weak.[4] The corporate tax increase has led to several instances of high-profile businesses preparing to move operations out-of-state before the state stepped in to mitigate the increased tax burden with a targeted incentive package.[5] The state has fallen considerably on our *State Business Tax Climate Index* as a result of the tax increases (see Table 2).

Table 2: Illinois and the *State Business Tax Climate Index*, 2011 to 2014

	2011	2012	2013	2014
Overall Rank	17	28	30	31
Corporate Income Tax Rank	26	45	47	47
Individual Income Tax Rank	10	11	11	11
Sales Tax Rank	34	33	34	33
Unemployment Insurance Tax Rank	41	43	43	43
Property Tax Rank	32	44	44	44

Source: Tax Foundation *State Business Tax Climate Index*

With the 2011 tax increases scheduled to sunset in part, and with the state budget still not structurally balanced, some policymakers may consider doubling down on bad tax policy. One proposal that has emerged in recent months is to consider a graduated, or progressive, income tax that would impose many additional rates on individual income. For example, (HJRCA0033) would amend the state constitution to allow a progressive income tax.[6] The plan includes seven tax brackets and a top rate of 9 percent, raising taxes on all income over $18,000.[7] Because the Illinois constitution currently requires individual income tax rates to be imposed uniformly on all income and all people, this proposed change would require 60 percent approval by legislators and a vote of the people to amend the constitution.[8]

Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive summary of international econometric tax studies, Arnold et. al. (2011) found

3 See Monique Garcia, *Illinois tax refunds to come with state spending information*, Chicago Tribune, Dec. 30, 2013, http://articles.chicagotribune.com/2013-12-30/news/chi-illinois-tax-returns-to-come-with-state-spending-information-20131230_1_topinka-refunds-state-lawmaker.

4 Benjamin VanMetre, *Illinois' Temporary Tax Hike: $18 Billion Later*, Illinois Policy Institute Fact Finder, Sep. 17, 2013, http://illinoispolicy.org/policy_posts/illinois-temporary-tax-hike-18-billion-later/.

5 Zoe Galland & Wangui Maina, *Illinois Companies Eyeing an Exit*, Chicago Tribune, http://www.chicagotribune.com/business/breaking/ct-biz-illinois-companies-leaving,0,5325079.photogallery; Scott Drenkard, *Illinois House Caves on Incentives for Sears and Chicago Mercantile Exchange*, Tax Foundation Tax Policy Blog, Dec. 13, 2011, http://taxfoundation.org/blog/illinois-house-caves-incentives-sears-and-chicago-mercantile-exchange; Aditya Yellajosyula, *Illinois Faces More Incentive Demands Due to High Corporate Rate*, Tax Foundation Tax Policy Blog, Oct. 17, 2013, http://taxfoundation.org/blog/illinois-faces-more-incentive-demands-due-high-corporate-rate; Joseph Henchman, *After Illinois Tax Increase, State Farm Reportedly Moving Operations to Texas*, Tax Foundation Tax Policy Blog, Feb. 15, 2013, http://taxfoundation.org/blog/after-illinois-tax-increase-state-farm-reportedly-moving-operations-texas.

6 Ben VanMetre, *Flat is Fair*, Illinois Policy Institute Blog, Oct. 22, 2013, http://illinoispolicy.org/flatisfair/.

7 HJRCA0033, 98th General Assembly, Regular Session (Ill. 2013), http://www.ilga.gov/legislation/billstatus.asp?DocNum=33&GAID=12&GA=98&DocTypeID=HJRCA&LegID=76587&SessionID=85.

8 Ill. Const. art. IX, sec. 3.

that personal income taxes are among the most destructive to growth, being outdone only by corporate income taxes.[9] The authors found that consumption and property taxes are the least harmful. The economic literature on progressive income taxes is especially unkind.[10] For example, the Arnold study found that reductions in top marginal income tax rates would be beneficial to long-term growth. Examining the period 1969-1986, Mullen & Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the principle of broad bases and low rates.[11] Prescott (2004) finds that high tax burdens over the last several decades in Europe have led workers on average to work fewer hours than Americans, whereas in the 1970s, the opposite was the case. He finds additional evidence that the flattening of the Spanish income tax system in 1998 increased the labor supply by 12 percent.[12] This suggests that progressive income tax policy today can hinder the long-run earning potential of a worker for the rest of their life. Finally, it should be kept in mind that many Illinois small businesses pay tax under the individual income tax code.

Looking exclusively at changes to income tax rates, had HJRCA0033 and the proposed rates been in place on July 1, 2013, the snapshot date for our 2014 *State Business Tax Climate Index*, Illinois would have ranked 44th best for business tax climate, rather than 31st (see Table 3). If corporate rates were made higher and more progressive as well, a change we do not consider here, Illinois' *Index* score would worsen further.

Table 3: Effect of higher tax rates on Illinois *State Business Tax Climate Index* rankings

	2014	2014 if HJRCA0033 and higher rates were law
Overall Rank	31	44
Corporate Income Tax Rank	47	47
Individual Income Tax Rank	11	33
Sales Tax Rank	33	33
Unemployment Insurance Tax Rank	43	43
Property Tax Rank	44	44

Source: Tax Foundation analysis.

9 *See* Jens Arnold, Bert Brys, Christopher Heady, Åsa Johansson, Cyrille Schwellnus, & Laura Vartia, *Tax Policy For Economic Recovery and Growth*, 121 Economic Journal F59-F80 (2011).

10 For a comprehensive review of 26 major academic studies evaluating the link between taxes and economic growth, *see* William McBride, *What is the Evidence on Taxes and Growth?*, Tax foundation special report no. 207 (Dec. 18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.

11 John Mullen & Martin Williams, *Marginal tax rates and state economic growth*, 24 Regional Science And Urban Economics 687-705 (1994).

12 *See, e.g.*, Edward C. Prescott, *Why Do Americans Work So Much More than Europeans?*, 28 Federal Reserve Bank of Minneapolis Quarterly Review 2-13 (2004), http://www.minneapolisfed.org/research/QR/QR2811.pdf.

The state-local tax burden borne by Illinois taxpayers rises year after year, and the state's efforts to offer large tax incentives to politically important businesses is an implicit acknowledgement that the state's tax code is uncompetitive and needs to be reformed. With credit ratings agencies suggesting that Illinois faces a risk of slipping back into recession, Illinois policymakers should address structural spending issues to repair the state's finances.[13] Extending what was meant to be a temporary tax increase, or significantly increasing the state's income tax still further, would sidestep these fundamental issues while worsening the state's already shaky economic footing.

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13 Moody's Analytics & Economic and Consumer Credit Analytics, *State of Illinois Economic Forecast: January 2013*, State of Illinois Commission on Government Forecasting & Accountability (Jan. 2013), http://cgfa.ilga.gov/upload/2013moodyseconomyilforecast.pdf.