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THE GRADUATED INCOME TAX PROPOSAL: AN ISSUE BRIEF

October 23, 2020

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The Civic Federation is an independent, non-partisan government research organization working to maximize the quality and cost-effectiveness of government services in the Chicago region and State of Illinois.

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INTRODUCTION

More than 50 years after Illinois began taxing residents' income, voters on November 3, 2020 will decide whether the structure of the income tax should undergo a major change. The issue is highly controversial, and the decision will have a long-lasting impact on the State's finances and its taxpayers.

Since Illinois' income tax was adopted in 1969, the State has had a flat income tax. Although tax rates have varied over the years, every taxpayer has paid the same rate, which is currently 4.95% for individuals.[1] That could change due to a proposed constitutional amendment that appears on the November 2020 ballot.[2] For the first time in the State's history, the measure would permit a graduated tax structure in which higher tax rates are applied at higher income levels.

The graduated tax amendment has been a priority for Governor J.B. Pritzker, who championed the proposal during his 2018 election campaign and has provided most of the funding for pro-amendment ads.[3] Other supporters include labor unions and advocates for low income residents and senior citizens. Opponents of the amendment have been led by prominent corporate executives and business organizations.

Based on the more than $100 million received by political committees on both sides of the issue,[4] experts expect the question to easily set a record for spending on a proposed constitutional amendment in Illinois. Before the graduated tax amendment, a total of $16.8 million was contributed for the five ballot measures in Illinois since 2003 and the most money devoted to a single amendment was $7.1 million in 2014, according to the National Institute on Money in Politics.[5]

The final decision will be up to Illinois voters. Amending the State's constitution requires the approval of either 60% of those voting on the question or a majority of those voting in the election.[6] Since these requirements took effect in 1971,[7] voters have approved 14 of the 22 proposed constitutional amendments on the ballot.[8] Of those approved, 10 have passed only

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[1] 35 ILCS 5/201(a) (5.4).

[2] Illinois Secretary of State, *Proposed Amendment to the Illinois Constitution*, p. 1, https://www.cyberdriveillinois.com/publications/con_amend/ca_english.pdf.

[3] Rick Pearson, "Fair tax or tax hike? Emotional arguments project hope and fear as voters set to decide what could be Illinois' biggest taxation shift in decades," *Chicago Tribune*, September 19, 2020.

[4] Illinois State Board of Elections, *Contributions Search*, https://www.elections.il.gov/CampaignDisclosure/ContributionSearchByAllContributions.aspx?MID=YJ6036pcmcQ%3d&T=637381934590124560. A total of more than $100 million has been contributed to Vote Yes for Fairness and the Coalition to Stop the Proposed Tax Hike Amendment.

[5] Communication between the Civic Federation and the National Institute on Money in Politics, October 15, 2020.

[6] Ill. Const. art. XIV, sec. 2(b).

[7] John Eggum, "Amending the Illinois Constitution – History, Precedent & Tax Provisions," *Illinois Association of Defense Trial Counsel Quarterly*, Volume 29, Number 4, 2019. The 1970 Illinois Constitution, which took effect on July 1, 1971, lowered the required margin from two-thirds of those voting on the question (66.67%) to three-fifths (60%).

[8] Illinois General Assembly, Legislative Research Bureau, *Constitution of the State of Illinois Amendments and Conventions Proposed*, https://www.ilga.gov/commission/lrb/conampro.htm.

because they met the 60% requirement, while the votes on the remaining four met both tests. It has generally been easier to get 60% of the vote on a ballot item because of the significant number of voters who have historically chosen not to vote on amendments.

This report is intended to provide voters with the information needed to make their own decisions on the question. Although the Civic Federation recently took a position against the tax amendment,[9] the report is based on blog posts and other material compiled before that policy decision.

[9] Civic Federation, "Civic Federation Position Statement on Proposed Illinois Constitutional Amendment for a Graduated Income Tax," October 20, 2020, https://www.civicfed.org/press-room/civic-federation-position-statement-proposed-illinois-constitutional-amendment-graduated.

HISTORY OF ILLINOIS' FLAT INCOME TAX

Of the 41 states with a general income tax, Illinois is one of only nine with a flat tax.[10] Before that tax was approved in 1969, there were unsuccessful attempts to establish a graduated income tax. The convoluted history of Illinois' income tax suggests that the tax was difficult to impose and the rate has not changed very often in the fifty years since its passage.

Early Efforts to Tax Income[11]

Until the Great Depression, Illinois relied on a statewide property tax for most of its revenue. The Illinois Constitution of 1870 contained a revenue article that authorized taxes on four categories: property, privileges, franchises and certain occupations. It also required that taxes on each category had to be uniform.[12]

A new constitution, designed to replace the 1870 governing document, was presented to voters in 1922. To address the State's growing revenue problems, the proposed revision included a provision for an income tax. The provision specified that the income tax rate could be graduated, but the highest rate could never exceed three times the lowest rate. The revised constitution was decisively rejected by voters for numerous reasons, including objections to the revenue proposal from both ends of the political spectrum.

The 1929 stock market crash and subsequent economic devastation led to broader support for income taxes. Illinois' property tax system virtually collapsed during the Depression, causing the General Assembly to abolish the statewide property tax and reserve its use for support of local governments. As an alternative State revenue source, the legislature in 1932 approved the creation of an income tax with graduated rates. The tax had six brackets, with rates ranging from 1.0% on the first $1,000 of income to 6.0% on income over $25,000.

However, the new tax was immediately struck down by the Illinois Supreme Court. The justices held in *Bachrach v. Nelson* that income must be considered as property and thus the new law's graduated rates violated the uniformity provision in the constitution.[13] The high court also held that the constitution prohibited the legislature from levying any new types of tax. The General Assembly was only allowed to add to the list of occupations, franchises and privileges listed in the constitution's revenue article.

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[10] Federation of Tax Administrators, *State Individual Income Taxes, February 2020*, https://www.taxadmin.org/assets/docs/Research/Rates/ind_inc.pdf. As discussed in more detail below, eleven of the 32 states with graduated taxes have very low top brackets, meaning that the highest tax rate applies at a relatively low income level and the resulting tax structure is only marginally progressive.

[11] Historical information summarized in this section is based largely on Janet Cornelius, *Constitution Making in Illinois*, 1818-1970 (Urbana: University of Illinois Press, 1972), pp. 85-138; Roland Calia, *The Institutional Origins of Social Policy in the American States*, 1996, University of Chicago, PhD dissertation, pp. 102-125; and Joyce Fishbane and Glenn Fisher, *Politics of the Purse: Revenue and Finance in the Sixth Illinois Constitutional Convention* (Urbana: University of Illinois Press, 1974).

[12] The 1870 Constitution required that "every person and corporation shall pay a tax in proportion to the value of his, her or its property," which was interpreted to mean that property taxes be general and uniform, rather than specific taxes levied on specific types of property. Joyce Fishbane and Glenn Fisher, *Politics of the Purse: Revenue and Finance in the Sixth Illinois Constitutional Convention* (Urbana: University of Illinois Press, 1974), p. 6.

[13] Bachrach v. Nelson, 182 N.E. 909 (Ill. 1932).

The *Bachrach* decision effectively blocked moves to levy an income tax for more than three decades. The General Assembly turned to the sales tax, approved in 1933, as the State's main revenue source. This tax was technically structured as a retailer's occupation tax, a constitutionally permissible tax on occupations.

Establishment of a Flat Tax

By the 1960s, consensus had begun to build for an overhaul of Illinois' fiscal system to provide an adequate financial base. Pressure was increasing for more State aid to schools and local governments due to rising local property tax rates. In 1967 the legislature approved increases in State and local sales tax rates that raised the combined rate to among the highest in the nation.

Facing a $1 billion budget deficit in fiscal year 1970, then-Governor Richard Ogilvie in April 1969 proposed a 4.0% flat income tax on individuals and corporations. With lukewarm support from his own party, the Republican Governor lowered the proposed rate on individuals to 2.5% to win support from Democratic legislators. The tax enacted on July 1, 1969 has been blamed for Governor Ogilvie's re-election loss in 1972 and for Republican loss of control of the State Senate in 1970.

The Illinois Income Tax Act was immediately denounced as unconstitutional, and the Illinois Supreme Court was asked to determine the statute's validity. In a surprising decision on July 25, 1969, the State's high court overturned *Bachrach* and ruled that the income tax could stand. The decision in *Thorpe v. Mahin* held that the income tax was not a property tax; that the legislature was not limited to levying taxes on occupations, privileges, franchises and property; and that uniformity did not prohibit distinctions among reasonable classes of taxpayers, such as individuals and corporations.[14]

The Income Tax Act and subsequent Supreme Court ruling came after voters approved the call for a constitutional convention in November 1968 and before the convention began in December 1969. One of the main issues on the convention's agenda was the imposition of an income tax.[15] After the *Thorpe* decision, there was little consideration of prohibiting income taxation in the new constitution. Business organizations favored limits on corporate taxes, while many education and labor groups sought graduated rates. However, the overriding concern was preserving the status quo by winning voters' support for a governing document that enshrined the previously enacted income tax.

The 1970 Constitution, approved by voters in December 1970, authorized a non-graduated income tax with one rate for individuals and one rate for corporations.[16] Although no specific rate limit was specified, the document required that the ratio between corporate and individual tax rates could not exceed eight to five; in other words, corporate rates could be at most 60%

[14] Thorpe v. Mahin, 250 N.E.2d 633 (Ill. 1969).
[15] In 1966 Illinois voters rejected a constitutional amendment authorizing a flat income tax rate of up to 5.0% for both individuals and corporations. Income tax proponents hoped a sweeping overhaul of the entire constitution would result in a more favorable outcome.
[16] Ill. Const. art. IX, sec. 3(a). See Appendix A for the existing and proposed language of this section.

higher than individual rates. That provision reflected the ratio in the Income Tax Act: 2.5% for individuals and 4.0% for corporations.

Modifying the Illinois Income Tax

The initial individual tax rate of 2.5% remained unchanged for 14 years, and many of the subsequent rate changes were temporary. The following table shows the history of individual income tax rates from 1969 to the present.

Illinois' Individual Income Tax Rates	
Effective Date	**Rate**
July 1, 2017	4.95%
January 1, 2015	3.75%
January 1, 2011	5.00%
July 1, 1989	3.00%
July 1, 1984	2.50%
January 1, 1983	3.00%
August 1, 1969	2.50%

Source: Illinois Economic and Fiscal Commission, *Illinois' Individual Income Tax* , May 2002, p. 2; 35 ILCS 5/ (Illinois Income Tax Act).

In 1983 the rate was temporarily raised to 3.0% for 18 months before reverting to 2.5% for another five years. The rate was again increased to 3.0% on July 1, 1989. It was scheduled to roll back to 2.5%, but the 3.0% rate became permanent on July 1, 1993 and remained in place through 2010.

The tax rate has been more variable in the past decade. Because the individual income tax is the State's largest revenue source, recent rate fluctuations have played a key role in Illinois' financial condition.

Following the Great Recession, the State approved a temporary increase in individual income tax rates to 5.0% midway through fiscal year 2011.[17] Corporate income tax rates, which had increased to 4.8% in 1989, were raised to 7.0%.[18] After four years at temporarily increased rates, the rates automatically declined on January 1, 2015 to 3.75% for individual income taxes and 5.25% for corporate income taxes.

The rate drop triggered a prolonged budget impasse, as a Republican Governor refused to raise income tax rates without pro-business policy changes that were blocked by a legislature under the control of Democrats. After two years without a complete budget, the deadlock was broken in July 2017, when the General Assembly overrode the Governor's veto and raised the individual rate to 4.95%.[19] Corporate rates were restored to 7.0%.

[17] Public Act 96-1496, signed on January 13, 2011.
[18] Corporations also pay a Personal Property Replacement Tax of 2.5%, which is effectively an additional tax on corporate income.
[19] Public Act 100-0022, enacted on July 6, 2017.

The individual tax rate is applied to Illinois net income. The starting point is federal adjusted gross income, which is modified by additions and subtractions to arrive at net income. The largest subtraction is for retirement and Social Security income that is taxed by the federal government but not by Illinois.[20] The personal exemption allowance—a flat amount for taxpayers, their spouses and each dependent—has increased from $1,000 in 1969 to $2,275 currently. Additional exemptions of $1,000 are available for taxpayers who are over 65 or blind. However, taxpayers with federal adjusted gross income over $500,000 for joint filers and $250,000 for single filers have not been eligible for exemption allowances since income tax rates were increased in July 2017.[21]

When the personal exemption was increased from $2,000 to $2,050 for tax year 2012, the amount was indexed for inflation for the next four years.[22] That law sunset in 2017 and the exemption rolled back to $2,000. A 2018 law reinstated the exemption at $2,050 plus inflation since 2011, but the exemption is scheduled to decline to $1,000 after tax year 2023.[23]

Tax bills may be further reduced by certain credits. The Illinois earned income tax credit, for example, is based on the federal earned income tax credit, a benefit for working people with low to moderate income that may result in a tax refund. The State credit was increased from 5% to 7.5% of the federal credit in 2012 and 10% of the federal credit starting in 2013.[24] The Illinois credit was increased to 14% of the federal credit in 2017 and 18% afterward. The maximum federal credit in tax year 2020 is $6,660.[25]

[20] Illinois State Comptroller, *Tax Expenditure Report Fiscal Year 2018*, August 2019, p. 4, https://illinoiscomptroller.gov/financial-data/find-a-report/tax-expenditure-report/fiscal-year-2018/.
[21] Public Act 100-0022, enacted on July 6, 2017.
[22] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Tax Handbook for Legislators*, August 2020, p. 62.
[23] Public Act 100-0865, enacted on August 14, 2018.
[24] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Tax Handbook for Legislators*, August 2020, p. 62.
[25] IRS, *Earned Income Tax Credit Income Limits and Maximum Credit Amounts*, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/earned-income-tax-credit-income-limits-and-maximum-credit-amounts.

THE ILLINOIS GRADUATED INCOME TAX PLAN

As discussed above, Illinois has had a flat rate—currently 4.95% for individuals—since the income tax was instituted in 1969. The Illinois Constitution mandates that any income tax be imposed at a single rate for all individual taxpayers, regardless of their income level.[26] The constitution also dictates a single corporate tax rate that may not be more than 60% higher than the individual rate.

In May 2019, at the urging of Governor Pritzker, the General Assembly approved a constitutional amendment to go before voters in November 2020 that removes the flat-tax requirement.[27] The amendment also modifies the corporate rate limit by requiring that the *highest* corporate rate not exceed the *highest* individual rate by more than 60%.

Additionally, the legislature approved a new graduated rate structure for individual income taxes that will take effect on January 1, 2021 if the constitutional amendment passes.[28] The following table shows the new Illinois individual income tax rates enacted in June 2019 in Public Act 101-0008. The legislation does not remove the tax exemption for all retirement income.

State of Illinois Proposed Marginal Income Tax Rates*

Proposed Marginal Rate	Net Income Range, Single Filer	Net Income Range, Joint Filer
4.75%	$0 to $10,000	$0 to $10,000
4.90%	$10,001 to $100,000	$10,001 to $100,000
4.95%	$100,001 to $250,000	$100,001 to $250,000
7.75%	$250,001 to $350,000	$250,001 to $500,000
7.85%	$350,001 to $750,000	$500,001 to 1,000,000
7.99%	Over $750,000**	Over $1,000,000**

*Marginal tax rates become effective only after passage of constitutional amendment in November 2020.

**The tax rate becomes flat in this range, meaning that all income is taxed at this rate.

Source: Public Act 101-0008, enacted on June 5, 2019.

The enacted graduated rates are similar to those proposed by Governor Pritzker in March 2019, less than two months after he took office.[29] The biggest difference is an increase in the top tax rate to 7.99% from 7.95% in the Governor's initial proposal. The legislation also raised the flat corporate rate to 7.99% from 7.95% in the Governor's proposal and the current 7.0%. (Illinois corporations also pay a Personal Property Replacement Tax of 2.5%, which is effectively an additional tax on corporate income.)

For those at higher income levels, the enacted tax plan includes a different rate structure for single tax filers and married couples. This change was intended to address criticism about a significant marriage penalty related to the Governor's initially proposed rate structure, which did

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[26] Ill. Const. art. IX, sec. 3(a).
[27] Senate Joint Resolution Constitutional Amendment No. 1, adopted on May 27, 2019, https://www.ilga.gov/legislation/101/SJRCA/PDF/10100SC0001lv.pdf.
[28] Public Act 101-0008, enacted on June 5, 2019, https://www.ilga.gov/legislation/101/SB/PDF/10100SB0687lv.pdf.
[29] State of Illinois Governor's Office, *Fair Tax for Illinois*, March 7, 2019, https://www2.illinois.gov/IISNews/19772-Fair_Tax_for_Illinois.pdf.

not distinguish between single and joint filers. A marriage penalty exists when joint filers have a higher combined tax burden than they would have had if they had remained single.

For single taxpayers with up to $750,000 of net income and joint filers with up to $1 million, the enacted plan uses a tax bracket structure applied in the same way as federal income taxes and most other states with graduated tax rates. The first dollars earned by all taxpayers are taxed at the lowest rates. Taxpayers earning more are subject to higher rates, but only on their net income above the threshold amounts for each bracket.

The tax rate applied to a filer's last dollar of income is called the marginal rate. The ratio of the total tax paid to net income is called the effective rate. In a flat-tax system, marginal and effective rates are the same. In a typical graduated tax system, except in the lowest income bracket, effective rates are below marginal rates due to lower marginal rates on the first dollars of income.

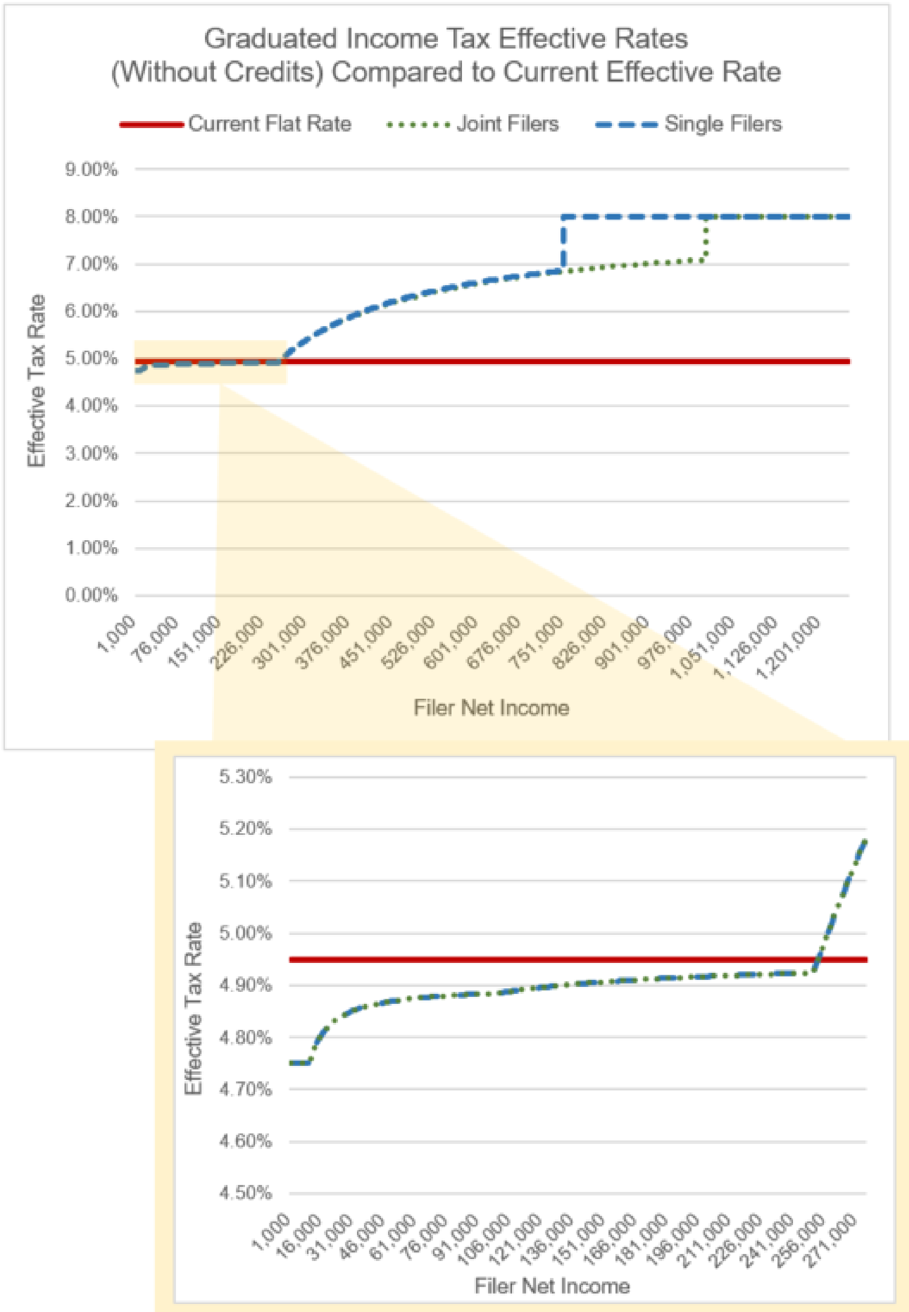
Under the Illinois plan, filers with up to $100,000 would see slightly lower marginal rates of 4.75% or 4.90%, compared with the current 4.95%. Filers with $100,001 to $250,000 would see no change in their marginal rate. Single filers with $250,001 to $750,000 and joint filers with $250,001 to $1 million would face higher marginal rates of up to 7.85%. However, filers with less than about $253,000 would see no increase in their effective rates because of the lower rates paid on lower brackets of income. The effective tax rate is 6.86% for single filers with $750,000 and 7.09% for joint filers with $1 million.

At the highest income levels, Illinois' enacted tax plan, like the Governor's initial plan, deviates from most states' graduated tax structures. For single taxpayers with more than $750,000 of net income and joint filers with more than $1 million, the tax rate becomes a flat 7.99%. That means that all income is taxed at the same rate, so the wealthiest taxpayers do not benefit from lower rates applied to their first dollars of income. Graduated income taxes that become flat at the top are rare, but not unprecedented, among other states. According to the Tax Foundation, two other states—Connecticut and New York—have similar structures, which are known as recapture provisions.[30]

The next chart, based on information provided by the Governor's Office of Management and Budget (GOMB), compares Illinois' current flat individual income tax rate with effective tax

[30] Jared Walczak and Katherine Loughead, Tax Foundation, *Twelve Things to Know About the "Fair Tax for Illinois*," October 2020, p. 7, https://taxfoundation.org/illinois-fair-tax/.

rates under the enacted plan. The calculations do not account for exemptions, deductions and tax credits, which would result in lower effective rates for most filers.



Source: Illinois Governor's Office of Managment and Budget

As shown above, the recapture provision results in a spike in effective tax rates. A single filer's effective rate jumps from 6.86% to 7.99% when net income increases from $750,000 to $750,001; the tax bill rises from $51,460 to $60,005. Joint filers see an increase in effective rates from 7.09% to 7.99% when their income rises from $1 million to $1,000,001; their tax bills increase from $70,935 to $79,980.

GOMB's latest available financial analysis of the new rate structure was done in June 2019 based on tax year 2016 returns. This analysis showed that 85.0% of the State's 6.2 million tax filers will see lower tax bills, while 2.8% will see higher bills. The remaining 12.2% do not owe any taxes. The 5.3 million filers with lower bills will have combined savings of $176 million, an average of $33 per filer. The 174,865 filers with higher bills will see a combined increase of $3.7 billion, an average of $21,434 per filer. Most of the increase is expected to be paid by the 19,939 taxpayers with more than $1 million of net income, who represent 0.3% of total filers. Their tax bills will increase by $2.8 billion, or $138,272 per filer.

Estimated Additional Annual Revenue from Graduated Income Tax (in $ millions)*

Net Income Range	Tax Year 2016 Returns	Tax Year 2016 Filer Net Income	Est. Additional Revenue
$0	757,409	$ -	$ -
$1 to $25,000	2,274,986	$ 25,389	$ (38)
$25,001 to $50,000	1,196,032	$ 43,374	$ (40)
$50,001 to $75,000	695,972	$ 42,777	$ (32)
$75,000 to $100,000	433,330	$ 37,491	$ (26)
$100,001 to $250,000	692,948	$ 101,263	$ (40)
$250,001 to $500,000	117,535	$ 39,588	$ 361
$500,001 to 1,000,000	37,391	$ 25,332	$ 630
Over $1,000,000	19,939	$ 62,138	$ 2,757
Total**	**6,225,542**	**$ 377,351**	**$ 3,574**

*June 2019 estimate. Effective upon passage of constitutional amendment in November 2020.

**Totals many not sum due to rounding.

Source: Illinois Governor's Office of Management and Budget.

These calculations did not account for tax credits in the new plan that could reduce taxpayers' bills. Public Act 101-0008 increases the property tax credit to 6% of property taxes paid per year from 5% and provides a child tax credit of up to $100 per year for single filers with under $80,000 and joint filers with less than $100,000.

In all, GOMB estimated additional individual income tax revenue due to the graduated tax plan (net of amounts set aside for tax refunds) of about $3.6 billion per year. This result assumed that the relatively rapid growth in high-income households in the years following the Great Recession would continue through 2020.[31] The calculation also assumed no income growth in 2021 from the previous year to make the estimate more conservative.

The next table shows GOMB's estimate of total annual revenues available for general operations, after adding proceeds from the increased corporate income tax rate and deducting the costs of tax

[31] For more information, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog post, "Governor Offers More Details on Graduated Income Tax Plan," March 21, 2019, https://www.civicfed.org/iifs/blog/governor-offers-more-details-graduated-income-tax-plan.

credits and distributions to local governments. The enacted plan reduced the local government share to $100 million from $237 million in Governor Pritzker's initial proposal.[32]

Estimated Annual Net Additional General Funds Revenue from New Tax Plan (in $ millions)*		
Graduated Income Tax	$	3,574
Corporate Income Tax Rate Increase	$	345
Local Government Distribution	$	(100)
Property and Child Tax Credits	$	(230)
Total	**$**	**3,589**

*June 2019 estimate.
Source: Illinois Governor's Office of Management and Budget.

If approved by voters, the plan would take effect midway through the current fiscal year, which began on July 1, 2020. The Governor's proposed budget for FY2021, issued in February 2020, relied on $1.435 billion from the proposed tax plan.[33] The $1.435 billion estimate was net of $100 million that the administration planned to use to shore up the State's severely underfunded retirement systems. The FY2021 budget also recommended that $200 million of the plan's proceeds in FY2022 and future years be devoted to the pension funds.

Like most government revenue forecasts, the Governor's projections for the graduated tax plan were upended by the COVID-19 pandemic. In April 2020 GOMB lowered the FY2021 estimate to $1.174 billion, a decrease of $261 million, or 18.2%, from the projection in the budget proposal.[34]

Since April, revenue estimates related to the new tax plan have not included supplemental pension contributions. The FY2021 budget passed by the legislature in May 2020 was based on potential graduated tax plan revenue of $1.274 billion—excluding any additional pension contributions.[35] Bond documents filed the same month had an annual revenue estimate of $3.1 billion on the same basis.[36]

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[32] For more information, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog post, "Does the Graduated Income Tax Plan Help Local Governments?" September 27, 2019, https://www.civicfed.org/iifs/blog/does-graduated-income-tax-plan-help-local-governments.

[33] Illinois State FY2021 Budget, pp. 143-144, https://www2.illinois.gov/sites/budget/Documents/Budget%20Book/FY2021-Budget-Book/Fiscal-Year-2021-Operating-Budget-Book.pdf.

[34] Illinois Governor's Office of Management and Budget, *April 2020 Revenue Forecast Revision*, April 15, 2020, pp. 2 and 5, https://www2.illinois.gov/sites/budget/Documents/April-2020-GOMB-Revenue-Forecast-Revision.pdf.

[35] Illinois Governor's Office of Management and Budget, *Fiscal Year 2021 Budget Highlights*, https://www2.illinois.gov/sites/budget/Documents/Budget%20Book/FY2021-Budget-Book/21665-Fiscal_Year_2021_Budget_Highlights.pdf.

[36] State of Illinois, General Obligation Bonds, Series of May 2020, *Official Statement*, May 13, 2020, p. https://www2.illinois.gov/sites/capitalmarkets/RecentBondSales/State%20of%20Illinois-General%20Obligation%20Bonds%20Series%20of%20May%202020-Official%20Statement.pdf.

INDIVIDUAL INCOME TAX STRUCTURES IN SELECTED STATES

This section of the report presents information about the different types of individual income taxes imposed by state governments in the United States.

In 2020 forty-one states levied individual income taxes. States currently use flat rate or graduated rate models for their individual income tax rate structures. Two states use a variation of the graduated income tax structure, employing "recapture" rates that combine both graduated and flat rate features. Every state has numerous exemptions, deductions and credits that alter the effective tax rate, the actual percentage of income paid in taxes. A subsequent section of this report presents information about effective tax rates and sample tax bills in different states.

Seven states do not impose any individual income taxes. They are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.[37] Two additional states impose income taxes only on interest and dividend income.

Flat Rate Individual Income Taxes

Nine states in 2020 used flat rate individual general income tax structures, imposing the same rate on all taxpayers regardless of income.[38] The rates range from 3.07% in Pennsylvania to 5.25% in North Carolina. These states tax all individual income.[39] On January 1, 2020, the individual income tax rate in Massachusetts fell from 5.05% to 5.0%, fully implementing a multiyear rate reduction approved by the voters in a 2000 ballot initiative.[40] Illinois currently has a 4.95% flat rate individual income tax.

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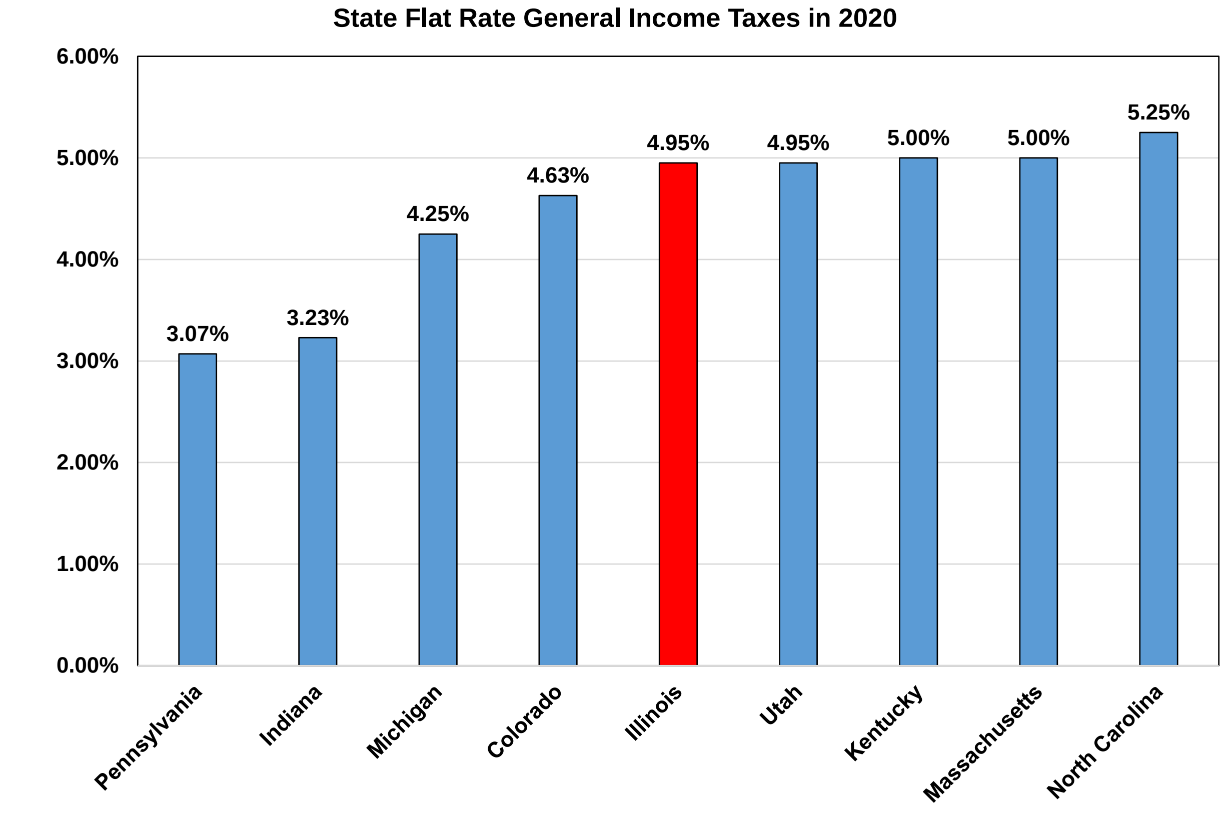
[37] Alaska repealed its income tax in 1979.

[38] In addition, two states, New Hampshire and Tennessee, tax only interest and dividend income. Tennessee began phasing out its income tax in 2017. That process will be completed in 2021 and Tennessee will join the group of states without an income tax. See Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020.

[39] Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020. Illinois and Pennsylvania do not tax any retirement income.

[40] Ballotpedia, "Massachusetts reduces state income tax to final rate set by 2000 ballot initiative," December 23, 2019, https://ballotpedia.org/Massachusetts_Income_Tax_Rate_Reduction_Initiative,_Question_4_%282000%29.

The following chart shows state flat rate income tax rates as of February 2020.



Source: Katherine Loughead. State Individual Income Tax Rates and Brackets for 2020. Fiscal Fact No. 693. Tax Foundation. February 2020.

Graduated Individual Income Taxes

A total of 32 states levied graduated individual income taxes in 2020.[41] Twenty-nine states impose graduated rates with different brackets. The brackets are income ranges taxed at the same rate. Within each bracket taxpayers pay the same rate. This means that taxpayers pay the same rate on income earned in the first bracket; after that they pay an increased rate up to a threshold amount per each bracket. The marginal rate is the tax rate applied to the last taxable dollar earned and is the top rate paid by each taxpayer. There may be different brackets for single and married taxpayers. Ten states have very low top brackets—less than $25,000—meaning their income tax structure is only marginally progressive.[42]

Each state applies various exemptions deductions and credits to the income tax base. This alters the effective tax rate, which is the actual percentage of income paid in taxes. The divergent tax treatments in various states make precise comparisons of income tax burden difficult.

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[41] Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020.

[42] These ten states are Alabama, Georgia, Idaho, Mississippi, Missouri, Montana, New Mexico, Oklahoma, South Carolina and Virginia. Katherine Loughead, State Individual Income Tax Rates and Brackets for 2020, Fiscal Fact No. 693, Tax Foundation, February 2020.

Graduated tax bracket rates in 2020 varied from a low of 0.33% on individual income up to $1,638 in Iowa to a high of 13.30% in California on individual income over $1.0 million. The number of tax brackets employed ranged from three in Alabama, Kansas, Maine, Mississippi and Rhode Island to twelve in Hawaii.[43] In contrast, federal individual income tax rates range from 10% to 35% in six brackets.[44]

Two states currently structure their graduated income taxes with a "recapture" feature: New York and Connecticut. This type of rate structure combines both graduated and flat rate features with brackets that impose graduated rates on income earned up to a certain threshold amount and then a flat rate tax on all income earned if the total is above that amount.[45]

Connecticut has seven income tax brackets with rates ranging from 3.0% to 6.99% for individuals earning up to $500,000 and married filers earning up to $1.0 million. All earned income if it is above those thresholds is taxed at a flat rate of 6.99%.

New York has eight tax brackets with rates ranging from 4.0% to 6.85% for individuals earning up to $1.077 million and married filers earning up to $2.15 million. All earned income if it is above those thresholds is taxed at a flat rate of 8.82%.

The Illinois legislature approved a recapture graduated income tax structure in May 2019.[46] The structure will take effect on January 1, 2021 if voters approve a constitutional amendment authorizing a graduated income tax in the November 2020 general election.

In the 2019 tax legislation, individual graduated rates start at 4.75% for incomes up to $100,000 and then increase up to 7.85% for single filers reporting between $350,000 and $750,000 in income, and for joint filers from $500,000 to $1 million. Single filers earning more than $750,000 and joint filers earning more than $1 million would be taxed at a flat rate of 7.99%.[47]

Recent Changes in Individual Income Tax Rate Structures

No state since 2000 has switched from a flat rate individual income tax structure to a graduated structure. However, three states have switched from a graduated individual income tax rate structure to a flat rate tax.

- Utah changed from a six-bracket tax structure with rates ranging from 2.3% to 6.98% to a flat rate 5.0% tax. The flat rate was further reduced to 4.95% in 2019.[48]

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[43] Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020.
[44] Internal Revenue Service, https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2019.
[45] Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020.
[46] Public Act 101-0008, enacted on June 5, 2019.
[47] Shelby Bremmer, "Illinois' Graduated Income Tax Plan: What You Need to Know," NBC Chicago, May 28, 2019, https://www.nbcchicago.com/news/local/illinois-income-tax-rates-progressive/131673/.
[48] Tax Foundation, "State Individual Income Tax Rates, 2000-2014," April 1, 2013, https://taxfoundation.org/state-individual-income-tax-rates/, and Katherine Loughead and Emma Wei, "State Individual Income Tax Rates and Brackets for 2019," Fiscal Fact No. 632, Tax Foundation, March 2019.

- North Carolina moved from a three-bracket graduated income to a 5.80% flat tax in 2014.[49] As of 2019, the rate was reduced to 5.25%.
- In 2018 Kentucky abandoned its six-bracket tax structure with a top rate of 6.0% for a 5.0% single rate tax.[50]

In addition, Arkansas consolidated its six-bracket tax schedule into four brackets in 2020. The top marginal rate was reduced to 6.6% from 6.9% for taxpayers earning over $79,300. The top rate for the next bracket – taxpayers earning between and $79,200 was dropped from 6.0% to 5.9%.[51]

Corporate Income Tax Rates

In 2019 a total of 44 states imposed corporate income taxes. Four of these states taxed net corporate income, while four states – Texas, Nevada, Ohio and Washington – taxed gross receipts. Fourteen states used a graduated tax structure and the remaining 30 imposed a flat rate tax.[52]

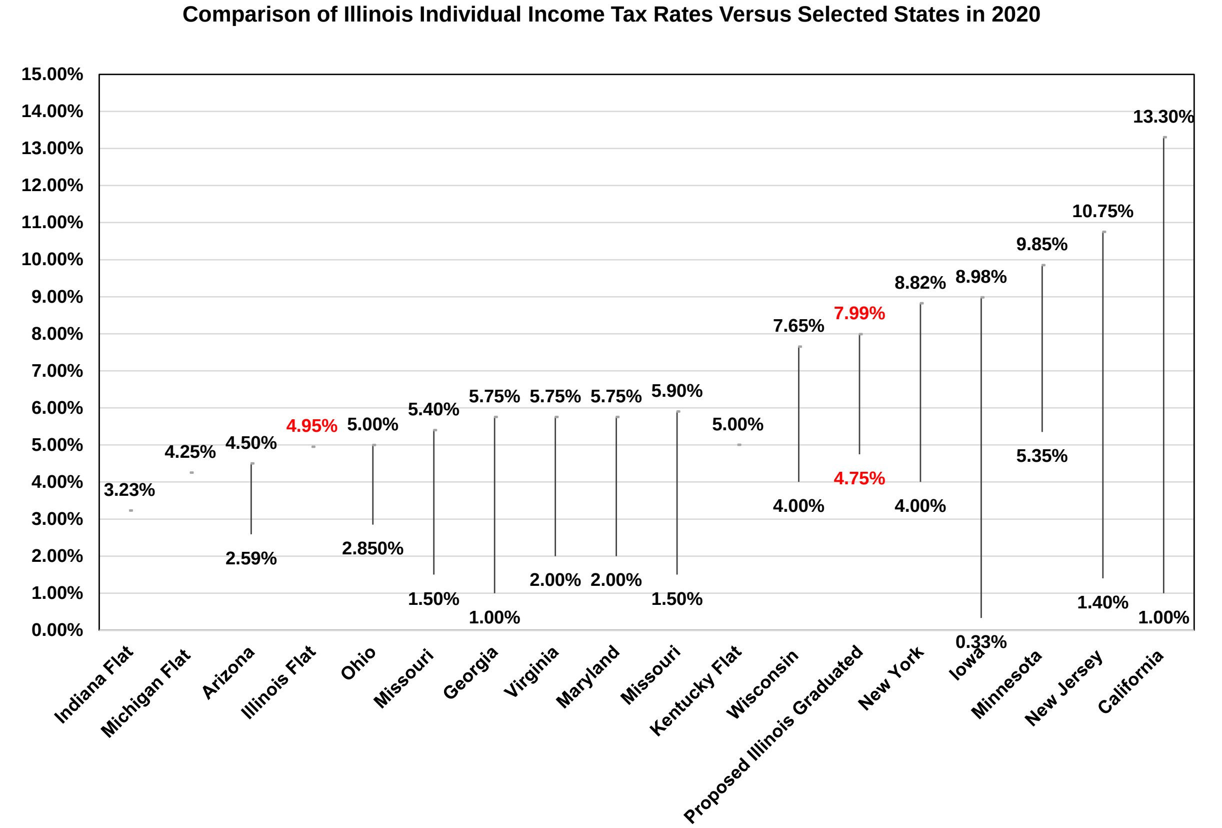
The Illinois legislation that establishes a graduated structure for individual income taxes also raises the State's existing flat corporate income tax rate if the constitutional amendment passes. The tax rate on corporate net income would increase to 7.99% from the current rate of 7.0%.[53] Illinois corporations also pay a personal property replacement tax (PPRT) of 2.5% on net income, which effectively will push the total Illinois corporate tax rate to 10.49%.[54]

Comparison of Illinois Individual Income Tax Rates versus Other States

The exhibit below compares Illinois' current flat and proposed graduated individual income tax rates with those in the most populous states imposing an income tax as well as the state's Midwestern neighbors. Currently, Illinois has one of the lowest individual income tax rates of the 17 states reviewed at 4.95%. Only Indiana, Michigan and Arizona have lower rates. If the graduated individual income tax is approved by voters in 2020, Illinois would have one of the

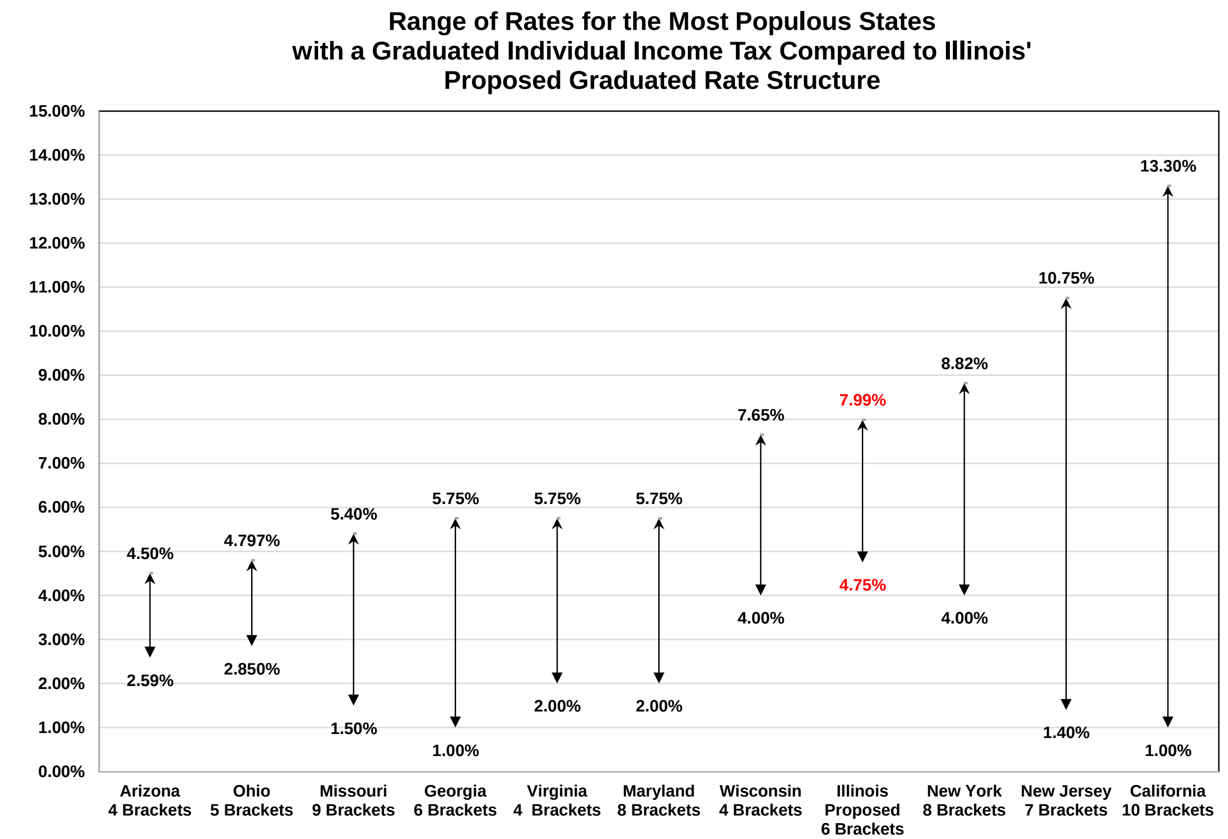
[49] Lyman Stone, "State Personal Income Tax Rates and Brackets 2014 Update," Tax Foundation, March 21, 2014, https://taxfoundation.org/state-personal-income-tax-rates-and-brackets-2014-update.
[50] Morgan Scarboro, "Kentucky Legislature Overrides Governor's Veto to Pass Tax Reform Package," April 16, 2018. Tax Foundation, https://taxfoundation.org/kentucky-tax-reform-package/.
[51] Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2020," Fiscal Fact No. 693, Tax Foundation, February 2020.
[52] Janelle Cammenga, "State Corporate Income Tax Rates and Brackets for 2020," Fiscal Fact No. 692, Tax Foundation, January 2020.
[53] Public Act 101-0008, enacted on June 5, 2019.
[54] Illinois Department of Revenue, https://www2.illinois.gov/rev/QuestionsAndAnswers/pages/242.aspx.

higher rates. Only five states—New York, Iowa, Minnesota, New Jersey and California—would have top rates higher than Illinois' top rate of 7.99%.



Source: Katherine Loughead. State Individual Income Tax Rates and Brackets for 2020. Fiscal Fact No. 693. Tax Foundation. February 2020.

The exhibit below shows the range of income tax rates for the most populous states levying graduated individual income taxes. Of these ten states, Arizona had the lowest top rate of 4.50% while California had the highest top rate at 13.30%.



Source: Katherine Loughead. State Individual Income Tax Rates and Brackets for 2020. Fiscal Fact No. 693. Tax Foundation. February 2020.

HOW WOULD THE ILLINOIS TAX BURDEN CHANGE UNDER THE GRADUATED INCOME TAX?

In the previous section, the current Illinois tax structure and the proposed graduated structure were compared to those in other states. This section illustrates how the current flat rate and a proposed graduated rate structure impact residents at different income levels by estimating the tax burden on six sample families in Illinois and comparing them to the burden in other states.

On March 7, 2019, Governor Pritzker released a presentation detailing how much in income taxes different groups of taxpayers would owe if the graduated income tax was approved by voters. Specifically, sample tax bills were presented for the following six scenarios:

1. Single parent who rents with two children earning $17,160.
2. Married couple with two children who earn $61,000 and pay $3,500 in property taxes.
3. Married couple with one child who earn $125,000 and pay $5,000 in property taxes.
4. Married couple with no children who earn $250,000 and pay $8,000 in property taxes.
5. Married couple with two children who earn $500,000 and pay $16,000 in property taxes.
6. Married couple with one child who earn $5,000,000 and pay $8,000 in property taxes.

This section compares the estimated income tax burden for those six taxpayer scenarios under the current Illinois flat rate income tax, the proposed graduated income tax and then also compares the income tax burden in the states of Wisconsin, Iowa, Indiana, Missouri, New York and California. Of these six states, only Indiana has a flat rate income tax – the others all have graduated rate structures.

The information presented in this section uses data from a recent Taxpayers' Federation of Illinois report entitled *The Proposed Graduated Income Tax in Illinois-A Closer Look*.[55]

Methodology

The following methodology was used to calculate the sample tax bills:[56]

1. Report base income.
2. Identify allowable exemptions and deductions.
3. Subtract exemptions and deductions from the base income to calculate net income.
4. Calculate income tax bill before credits by applying the tax rate to the net income figure.
5. Deduct state Earned Income Tax Credit (EITC) if applicable.
6. Deduct property tax credit, if applicable.
7. Deduct child tax credit, if applicable.
8. Calculate the final income tax bill or refund by subtracting applicable credits from the tax before credits figure.

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[55] Taxpayers' Federation of Illinois. *The Proposed Graduated Income Tax in Illinois-A Closer Look*, August/September 2020, https://www.illinoistax.org/index.php/the-proposed-graduated-income-tax-in-illinois-a-closer-look/.

[56] Communication between the Civic Federation and the Taxpayers' Federation of Illinois, October 8, 2020.

The sample tax bills presented are estimates for families living in the most populous jurisdiction in each of the selected states. In Indiana, Missouri and New York, local as well as state income taxes are factored into the tax bill calculations. The Iowa sample tax bills do not include school district income tax surcharges because Des Moines, the Hawkeye State's most populous city, does not have such a tax, unlike other Iowa jurisdictions.[57]

Marginal vs. Effective Tax Rates

As discussed above, the tax rate applied to a filer's last dollar of income is the marginal rate. The ratio of the total tax paid to net income is the effective rate. In a flat-tax system, marginal and effective rates are the same. In a typical graduated tax system, except in the lowest income bracket, effective rates are below marginal rates due to lower marginal rates on the first dollars of income. The six sample income tax bills presented here are based on an effective rate calculation that compares taxable income to the amount of taxes paid. For the five states with graduated income tax structures, the effective rate is a blended or weighted average rate. Indiana has a flat rate income tax, so its marginal and effective tax rates are similar.[58]

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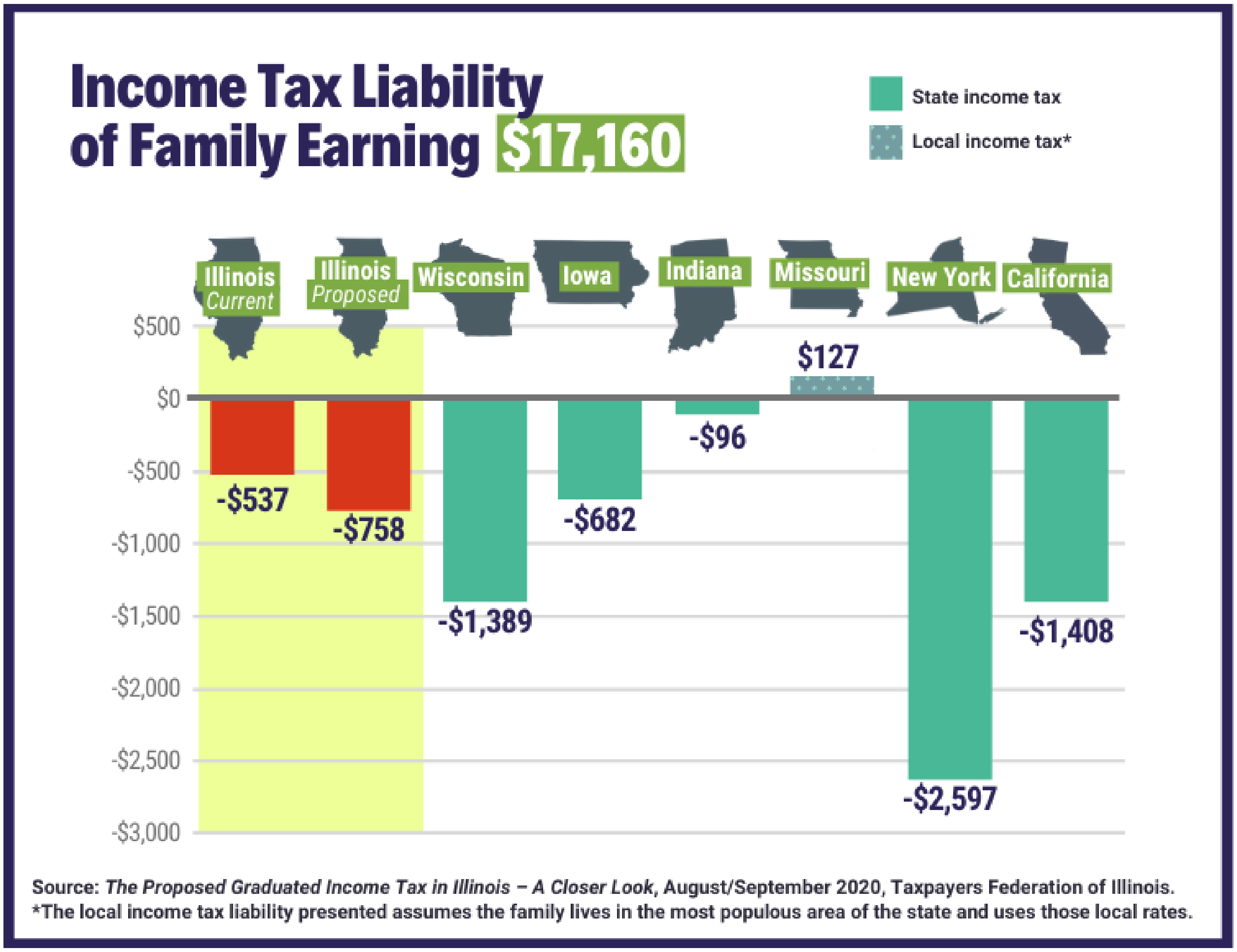
[57] Indiana counties, such as Marion County, impose a county level income tax. Kansas City and St. Louis impose a 1% earnings tax. New York City imposes a graduated income tax with a top rate of 3.876%. Taxpayers' Federation of Illinois, *The Proposed Graduated Income Tax in Illinois-A Closer Look*, August/September 2020, p. 4.
[58] Taxpayers' Federation of Illinois, *The Proposed Graduated Income Tax in Illinois-A Closer Look*, August/September 2020, pp. 3-4, https://www.illinoistax.org/index.php/the-proposed-graduated-income-tax-in-illinois-a-closer-lookS/.

Scenario Analysis

The income tax burden on the six example families described above was calculated under the current Illinois flat tax, the proposed Illinois graduated income tax and for six other states.

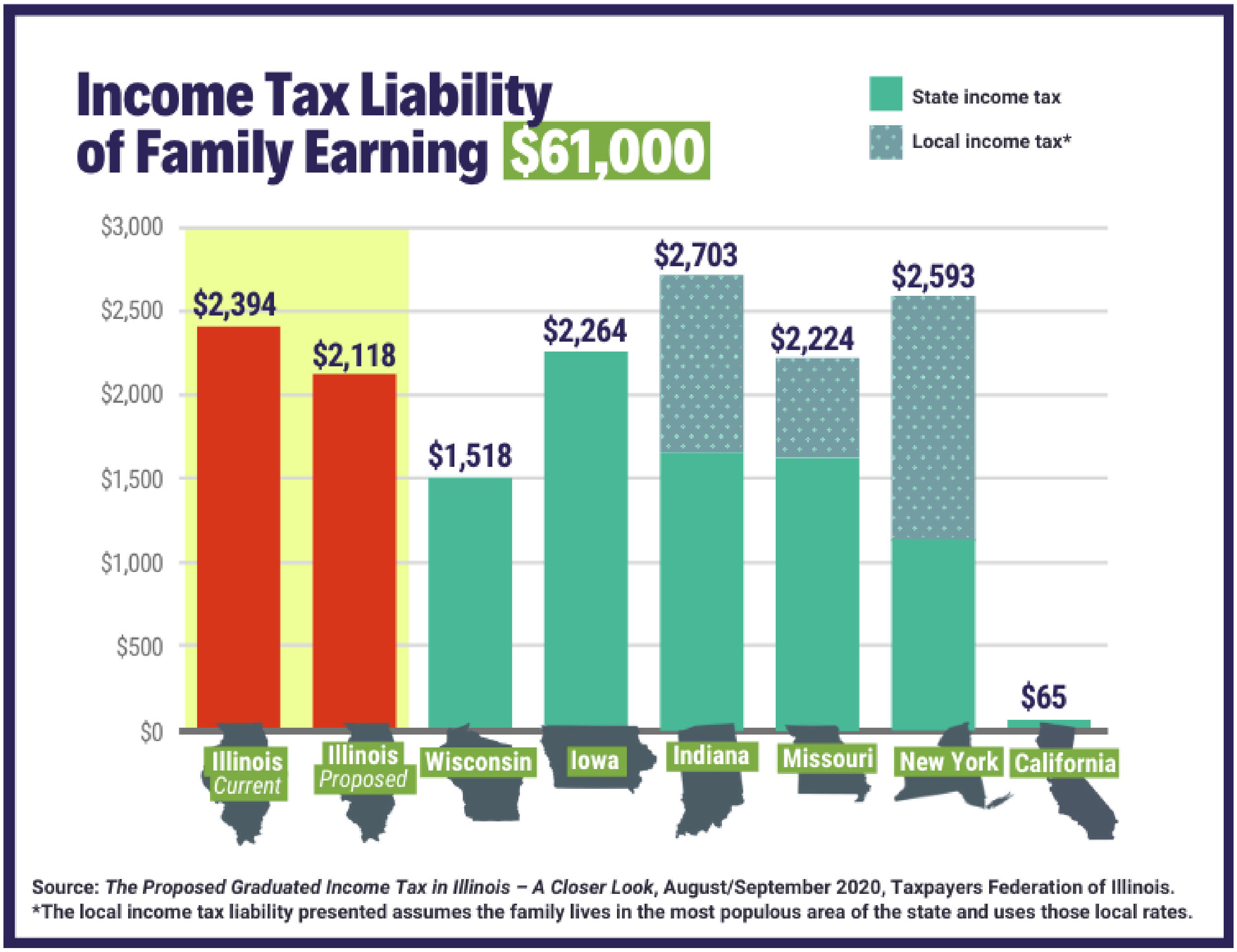
Single parent who rents with two children earning $17,160

This scenario presents a sample tax bill for a single parent with two children who rents their dwelling. Under current Illinois law, these taxpayers would receive a $537 refund. The amount would increase to $758 if the graduated income tax is approved; part of this increase is due to eligibility for a new child tax credit. The same family would receive a refund in all comparison states except Missouri.



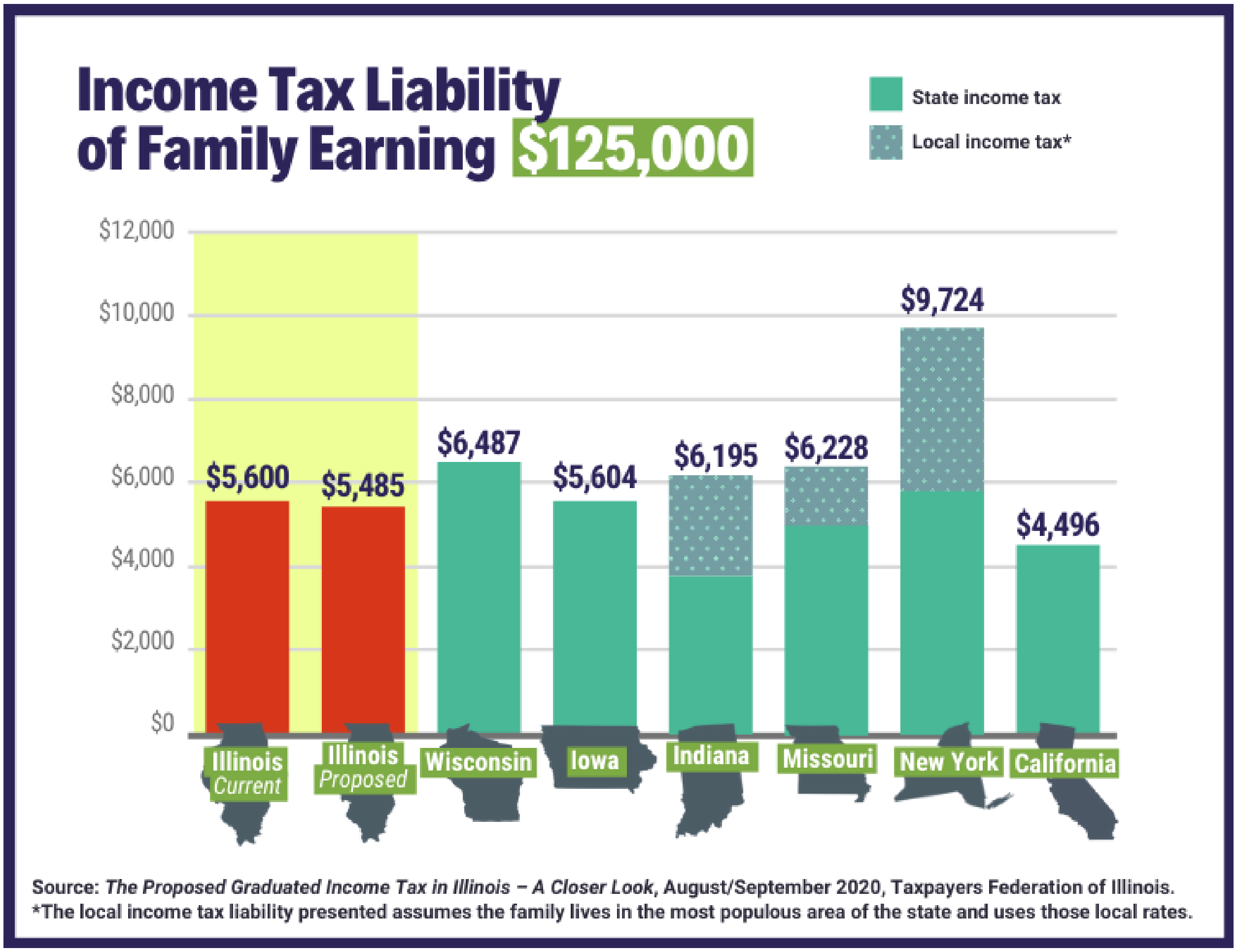
Married couple with two children who earn $61,000 and pay $3,500 in property taxes

Under this scenario, a married couple with two children earning $61,000 and paying $3,500 in property taxes would get a 12% or $276 reduction in income taxes under a graduated income tax schedule from their current Illinois liability. Their new tax liability would drop from $2,394 to $2,118. It would be higher than similar taxpayers in Wisconsin or California and a bit less than taxpayers in Iowa, Indiana, Missouri and New York.



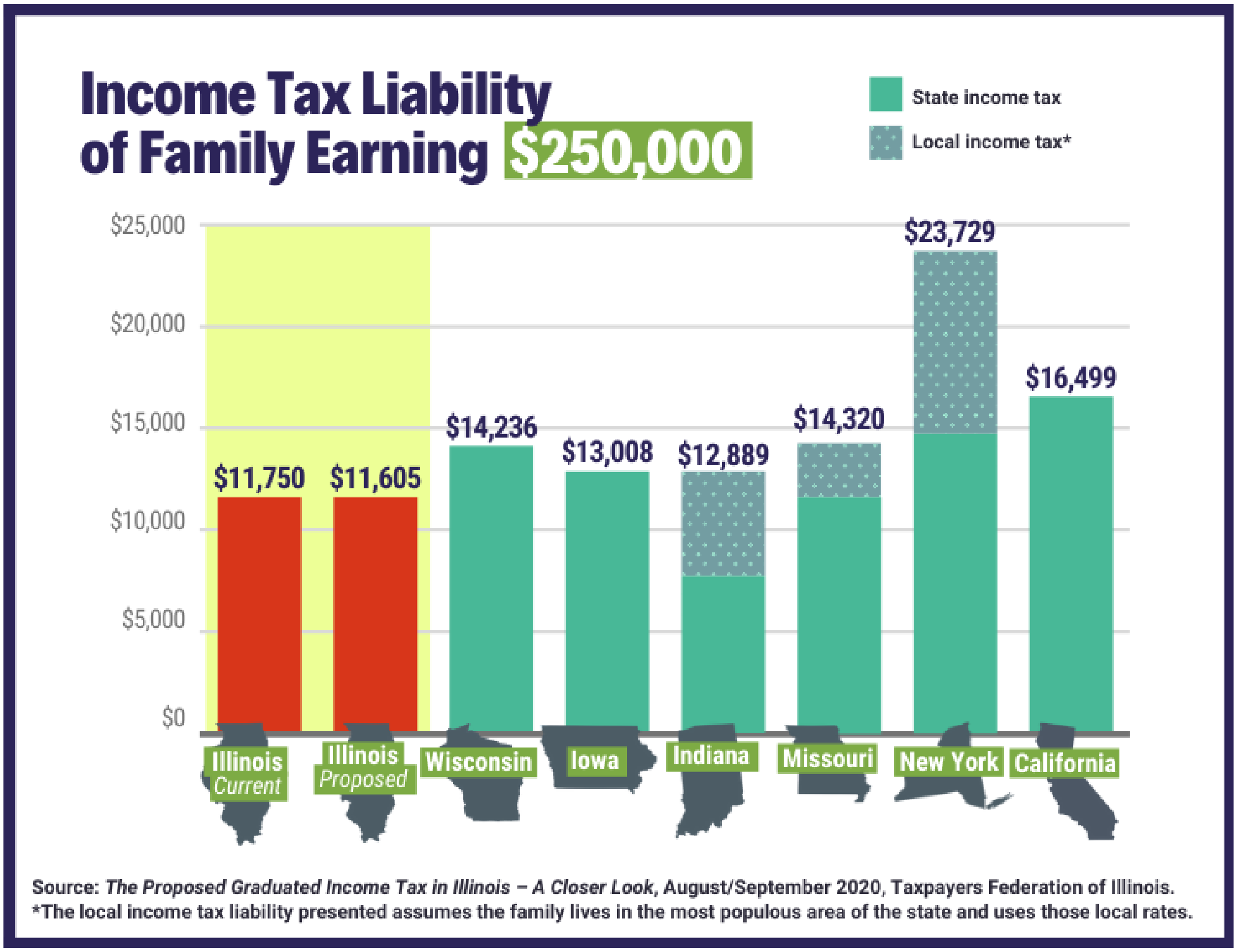
Married couple with one child who earn $125,000 and pay $5,000 in property taxes

Married Illinois couples with one child earning $125,000 and paying $5,000 in property taxes would receive a $115, or 2.1%, income tax reduction under Governor Pritzker's fair tax plan. Their taxes would decrease from $5,600 to $5,485. These taxpayers would pay less in income taxes than they would if they lived in all of the comparable states reviewed except California.



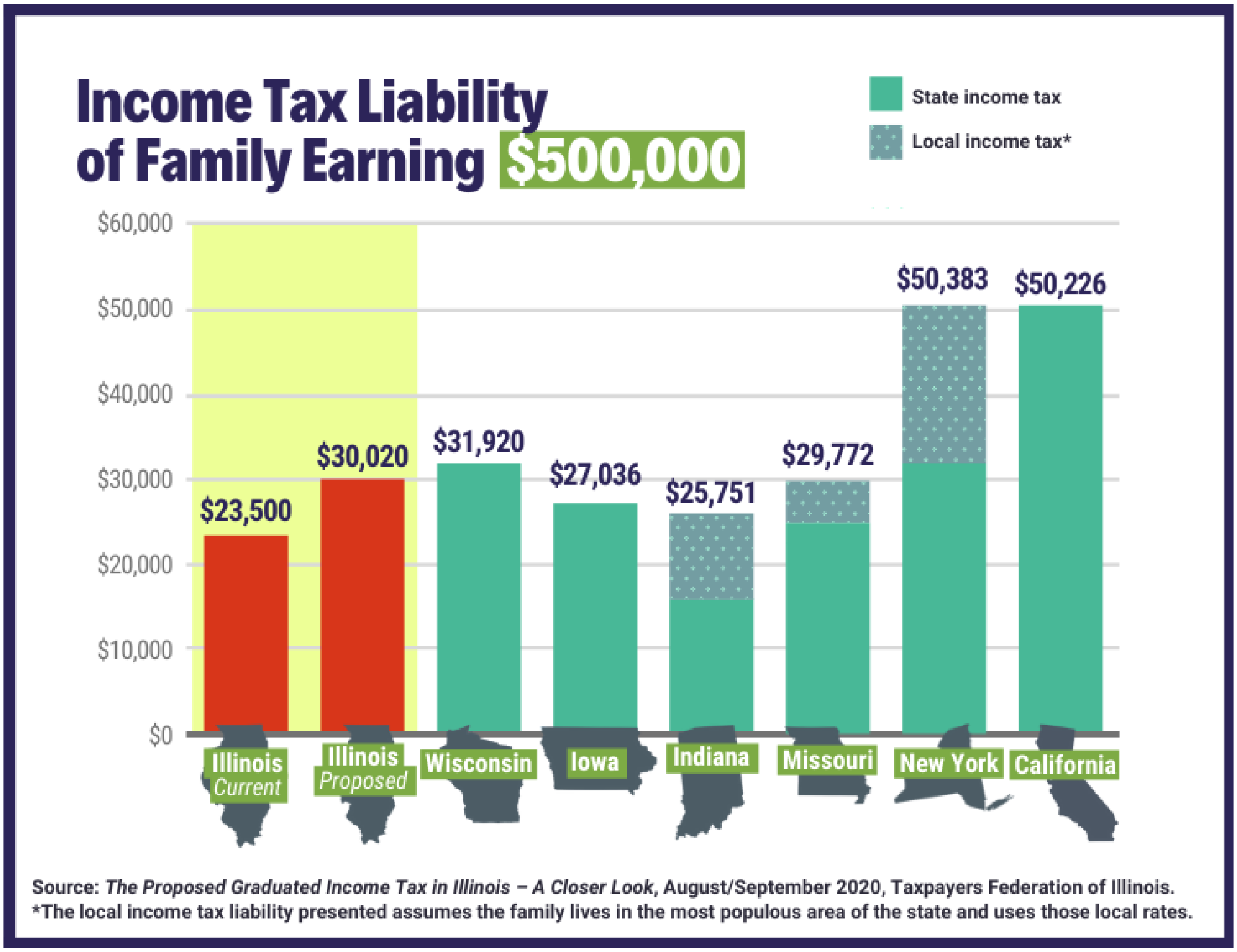
Married couple with no children who earn $250,000 and pay $8,000 in property taxes

Illinois childless couples that earn $250,000 and pay $8,000 in property taxes would see their income taxes fall from $11,700 to $11,605, a 1.2% or $145 decrease. The Illinois couple would pay lower income taxes than their counterparts in all the other selected states.



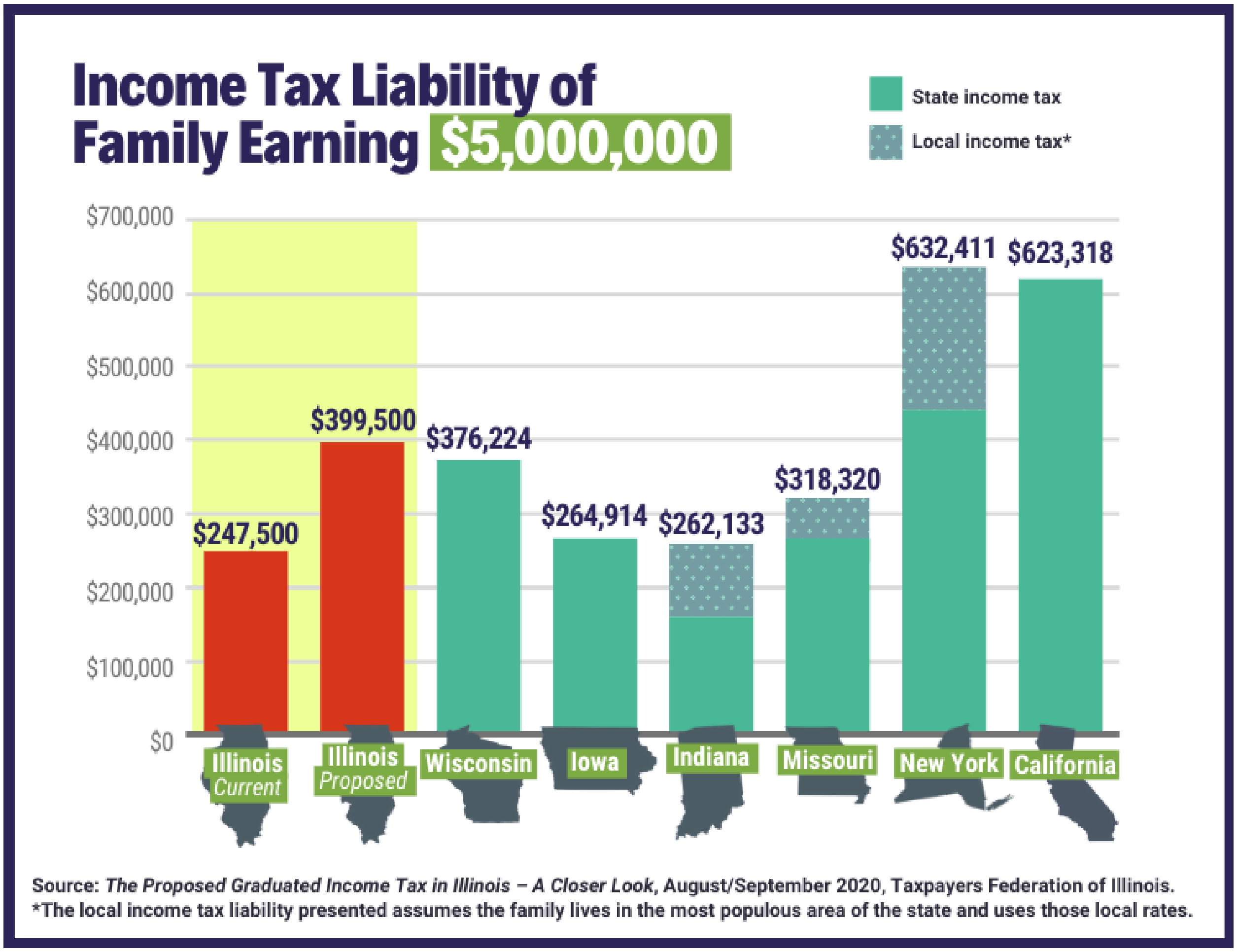
Married couple with two children who earn $500,000 and pays $16,000 in property taxes

A married couple with two children earning $500,000 and paying approximately $16,000 in property taxes would experience a 27.7% or $6,520 increase in income taxes. This would increase their tax liability from $23,500 to $30,020. For this cohort, their tax burden would be higher than their counterparts in Iowa, Indiana and Missouri. But it would be less than for similar taxpayers in Wisconsin, New York and California.



Married couple with one child who earn $5,000,000 and pay $8,000 in property taxes

Illinois married couples with one child earning $5 million who pay $8,000 annually in property taxes would see a substantial 61.4% increase in their income tax liability if the graduated income tax is approved. This would represent a $152,000 increase from $247,500 to $399,500. Under this scenario, Illinois income taxes would be higher than those for this cohort in Wisconsin, Iowa, Indiana and Missouri. They would be less than taxes paid in New York and California.



Summary of Findings

As the sample tax bills demonstrate, the proposed Illinois graduated income tax would introduce vertical equity into the state's tax system. Tax burden would be shifted to higher income individuals and families, who would pay more in income taxes. At the same time, lower, middle and upper middle income taxpayers would see some reduction in their tax burden. Their income tax bills would be somewhat lower than under the current system.

THE GRADUATED INCOME TAX AND TAX POLICY CONSIDERATIONS

Previous sections of this report describe Illinois' proposed new income tax structure but do not discuss how to evaluate it. Economists have developed principles to guide governments in raising revenue with the least possible economic and social harm. Among public finance experts, there is general agreement that tax policy should be judged on the principles of revenue adequacy, equity, collectability/simplicity and economic efficiency.[59]

Principles of taxation alone cannot resolve arguments about tax policy, which is an inherently political or philosophical issue. For example, graduated tax plan opponents argue that Illinois officials cannot be trusted to spend new revenue wisely, given the State's history of financial mismanagement—as evidenced by severely underfunded pensions, a multi-billion dollar backlog of unpaid bills and the lowest credit rating of any state.[60] Supporters say additional revenue from the proposed new tax structure is needed to pay for essential public services, especially during the COVID-19 crisis.[61] Nevertheless, tax principles can improve the debate by focusing attention on the economic tradeoffs involved in any tax proposal.[62]

This report focuses on individual income taxes, but it should be understood that they are only one component of a tax system. A principle of taxation that is violated by the income tax may be satisfied by other taxes in the system. The goal for any government is a balanced tax system with a diversity of revenue sources.[63] With diverse revenue sources, a government is better equipped to handle economic fluctuations and distribute the cost of providing services.

Tax Principles

Revenue adequacy refers to the ability of a specific tax to generate significant revenue at a reasonable tax rate. It is important that a tax produce sufficient revenue to support the level of government services demanded by residents. Tax revenue is the product of the tax rate and the tax base—the amount of economic activity subject to taxation. Tax rates that are too low will not generate enough revenue, but high tax rates create incentives to avoid the tax, thus lowering the tax base and reducing collections. In addition, revenue adequacy must be evaluated over time based on stability and prospects for growth.[64] Revenue stability relates to how taxes respond to short-term cyclical economic fluctuations; a tax that is highly responsive to economic activity will perform well during cyclical upswings but could produce drastic revenue shortfalls during downturns in the economy. On the other hand, a tax that provides stable revenue in the short run

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[59] John L. Mikesell, *Fiscal Administration: Analysis and Applications for the Public Sector* (Boston: Wadsworth, 2014), 350-353. Some economists also include transparency, which involves taxpayers' access to key information about the taxes they must pay, as a fundamental standard for judging taxes.
[60] Crain's Editorial Board, "Vote 'no' on the graduated tax," *Crain's Chicago Business*, September 18, 2020.
[61] CST Editorial Board, "How you know the Fair Tax is good for you—consider the fat cats trying to kill it," *Chicago Sun-Times*, October 9, 2020.
[62] Daniel Carroll, "The Economics of Taxation," Federal Reserve Bank of Cleveland, *Forefront*, Spring 2012.
[63] National Advisory Council on State and Local Budgeting, Government Finance Officers Association, *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting*, Practice 4.6: Develop Policy on Revenue Diversification, June 1999, p. 25.
[64] Richard F. Dye, "State Revenue Cyclicality," *National Tax Journal*, March 2004, p. 135.

might not grow fast enough to support the rising costs of government services or to meet increases in demand for services over a longer period of time.

Equity involves the fairness of a tax or how the tax burden should be distributed among taxpayers.[65] Economists divide this issue into two elements: horizontal equity and vertical equity. Horizontal equity requires that taxpayers with equal capability to pay a tax be treated the same. Vertical equity concerns the relative tax burdens that are appropriate for individuals with different capabilities to pay. The question is whether the share of a taxpayer's resources required to pay a tax should be equal for all taxpayers, greater for the less affluent or greater for the more affluent. The answer—which will result in taxes that are proportional, regressive or progressive, respectively—depends on economic assumptions and personal philosophy.

Collectability/simplicity involves the cost of collecting taxes, which should be as low as possible for both governments and taxpayers. Simple taxes are less costly for taxpayers to comply with and for governments to administer. A complex tax requires taxpayers to spend more time and money gathering documents and computing tax liability and demands a larger administrative staff and more sophisticated equipment to implement. Less complicated taxes also promote public understanding, confidence and compliance. However, tax simplicity may be at odds with policy goals such as correcting perceived inequities or improving economic incentives. For example, economists believe that the simplest tax is a head tax, a fixed-dollar tax on everyone.[66] But a head tax is generally regarded as unfair because it does not take account of differences in incomes.

Economic efficiency refers to the effect of taxes on economic behavior. The guiding principle is that tax policy should be aimed at having as little impact as possible on personal or business behavior because market-based decisions are the most efficient. In practice, taxes are frequently intended to encourage or discourage certain activities, and the economic distortion they create is seen as a socially desirable improvement. Examples are business tax credits to encourage investment and sin taxes on tobacco to discourage smoking. In general, however, economists believe that changes in behavior can be prevented by keeping tax rates low, avoiding different tax rates on similar products and activities and avoiding taxes in markets that respond dramatically to price changes.

Flat Income Tax vs. Graduated Income Tax

How do these principles come into play when comparing Illinois' existing flat tax with the graduated tax structure that would go into effect if the constitutional amendment is approved by voters in November?

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[65] Government services that provide benefits to specific individuals, such as public utilities and toll roads, can be financed by user fees. However, most public services provide broad social benefits that are not easily divisible.

[66] Tax Policy Center, *The Tax Policy Briefing Book*, pdf p. 312, https://www.taxpolicycenter.org/sites/default/files/briefing-book/bb_full_2018_1.pdf (last accessed on October 16, 2020). A head tax is also considered to be the most efficient tax because the amount paid does not depend on economic decisions.

Revenue adequacy

Although revenue estimates are imprecise, particularly during a pandemic, it is likely that the new tax structure could bring in significant new revenue. The additional funding would come as Illinois is facing a projected gap of $6.4 billion between general operating revenues and expenditures in the current fiscal year, which ends on June 30, 2021.[67] Governor Pritzker has warned of steep spending cuts in FY2021 and FY2022 if more federal financial relief is not forthcoming,[68] and the graduated tax plan revenue could close part of the deficit. Credit rating firms have indicated that voter rejection of the proposed amendment could impact Illinois' ability to manage its deficit, which is a consideration in its credit rating, currently one notch above non-investment status.[69]

Opponents of the tax plan argue that revenue forecasts are too rosy because the highest earners will leave Illinois to avoid the higher rates.[70] Illinois' population has declined in each of the last six years and it is one of only four states that has lost population in the last decade.[71] However, research on the link between millionaire taxes and out-migration has been inconclusive.[72]

Even if the projections about annual revenues from the plan are realized, that money would not solve Illinois' underlying financial problems. The total unfunded liability of the State's five retirement system was $137.2 billion at the end of FY2019 and the combined funded ratio stood at 40.3%.[73] Even with General Funds pension payments projected to absorb 26% of State-source revenue in FY2021,[74] Illinois' contributions to its retirement systems are not expected to be

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[67] State of Illinois, General Obligation Bonds, Series of October 2020, *Preliminary Official Statement*, October 8, 2020, p. 39, https://www2.illinois.gov/sites/capitalmarkets/RecentBondSales/State%20of%20Illinois%20General-Obligation%20Bonds%20Series%20of%20October%202020%20ABCD%20Preliminary%20Official%20Statement.pdf. In addition to the graduated tax proposal, the FY2021 budget would close the gap with $5 billion of borrowing from the Federal Reserve's Municipal Liquidity Facility or additional federal financial relief, as well as $150 million in borrowing from other State funds.

[68] Dan Petrella, "With no help forthcoming from Washington, Gov. J.B. Pritzker asks state agencies to prepare for 'nightmare scenario' of budget cuts," *Chicago Tribune*, September 14, 2020.

[69] Fitch Ratings, *Fitch Affirms Illinois IDR at 'BBB-', Rates $850 Million GO Bonds 'BBB-'; Outlook Remains Negative*, October 7, 2020.

[70] Illinois Chamber of Commerce, "Independent Analysis: Graduated Income Tax Hike Disproportionately Affects Women & Minorities, Shrinks Illinois Economy by Nearly $2 Billion, Increases Consumer Costs, Leads to Reduced Household Spending," *news release*, August 6, 2020.

[71] Robert Gebeloff, "Why Your State Is Growing or Stalling or Shrinking," *The New York Times*, January 9, 2020.

[72] A.D. Quig, "Here's what really happens when states raise taxes on millionaires," *Crain's Chicago Business*, September 25, 2020.

[73] Illinois General Assembly, Commission on Government Forecasting and Accountability, Illinois State Retirement Systems Condition as of June 30, 2019, June 2020, p. 42, https://cgfa.ilga.gov/Upload/FinConditionILStateRetirementSysJune2020.pdf.

[74] Illinois Governor's Office of Management and Budget, *Fiscal Year 2020 Fourth Quarter Financial Review*, p. 6, https://www2.illinois.gov/sites/budget/Documents/General%20Funds%20Operating%20Quarterly%20Reports/General-Funds-Quarterly-Report-Q4-FY20v2.pdf. General Funds pension contributions are $8.624 billion and State-source revenues (excluding federal revenues deposited into General Funds) are projected at $33.085 billion.

sufficient to keep unfunded liabilities from growing until FY2029.[75] The State's backlog of unpaid bills was recently estimated at $8.8 billion.[76]

Moreover, the particular structure of Illinois' graduated tax plan—with so much of the projected additional revenue coming from the highest earners—leads to concerns about revenue volatility. Net income is much more volatile at the highest levels because upper incomes depend more on investment income, which varies with stock market performance and the business cycle.[77] While a top-heavy tax structure will lead to higher revenues on average, it will also increase their variance.[78] Other states use specially designated budget reserves to help manage revenue volatility, but Illinois has never maintained a functioning rainy day fund.

Equity

As the Taxpayers' Federation of Illinois recently pointed out in a report about the proposed graduated tax plan, fairness is in the eye of the beholder.[79] Amendment supporters call the proposed tax the "fair tax" because it will shift more of the burden of income tax payments to taxpayers with the most income.[80] The argument is that high income families spend less as a percentage of their income on necessities such as food and housing, so they can afford to pay more in taxes. Some critics believe that flat taxes are fairer because everyone pays the same rate, resulting in higher payments by households with more income.[81]

According to the Institute on Taxation and Economic Policy, Illinois' individual income tax is already mildly progressive, despite the flat tax, due partly to tax credits and exemptions.[82] Tax filers with the lowest 20% of family income pay 1.5% in income taxes, while the top 20% pay 3.8% and the top 1% pay 4.1%. However, Illinois' overall tax system, including sales and property taxes, is highly regressive: the bottom 20% pay 14.4% of their income in State and local taxes, while the top 20% pay 11.8% and top 1% percent pay 7.4%.

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[75] Illinois General Assembly, Commission on Government Forecasting and Accountability, Illinois State Retirement Systems Condition as of June 30, 2019, June 2020, p. 117, https://cgfa.ilga.gov/Upload/FinConditionILStateRetirementSysJune2020.pdf (last accessed on October 19, 2020).
[76] Illinois State Comptroller, *Backlog Voucher Report*, October 19, 2020, https://illinoiscomptroller.gov/financial-data/backlog-voucher-report-bvr/.
[77] For more information, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog post, "Governor Offers More Details on Graduated Income Tax Plan," March 21, 2019, https://www.civicfed.org/iifs/blog/governor-offers-more-details-graduated-income-tax-plan.
[78] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98 – 0682*, February 27, 2015, pp. 55-56, https://cgfa.ilga.gov/Upload/IllinoisRevenueVolatilityStudy_2014CGFA.pdf.
[79] Taxpayers' Federation of Illinois, *The Proposed Graduated Income Tax in Illinois—A Closer Look*, August/September 2020, pp. 2 and 10.
[80] AARP, Where AARP Stands on IL Graduated Income Tax Amendment, https://states.aarp.org/illinois/where-aarp-stands-on-il-graduated-income-tax-amendment.
[81] Illinois Capitol News, Maisch: "The flat tax is really the fair tax," *WCIA.com*, January 5, 2020.
[82] Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, October 2018, pp. 58-59.

Collectability/Simplicity

In theory, flat taxes should be simple to administer and pay. However, because of credits, exemptions and other adjustments, even flat-rate income taxes are somewhat complicated. A tax handbook for Illinois lawmakers lists ten additions and 21 subtractions from federal adjusted gross income to arrive at net income, on which the current flat tax rate is applied.[83] Another thirteen tax credits are available to reduce the final bill. The graduated tax structure is more complicated, with six brackets and different brackets at the top for single and married taxpayers. This means there will be additional costs for taxpayers to comply with the new structure and for the government to administer it.

Economic efficiency

Individual income taxes clearly influence work and investment decisions, thus reducing economic efficiency. As taxes get higher and more complicated, individuals have more opportunity and motivation to spend time and money on strategies to avoid paying them.[84] This is particularly true for the wealthy, who have more resources to devote to tax avoidance strategies. The proposed graduated tax structure, which specifically targets high income individuals, could be expected to increase this kind of activity and reduce economic efficiency.

[83] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Tax Handbook for Legislators*, August 2020, p. 62.
[84] Taxpayers' Federation of Illinois, *The Proposed Graduated Income Tax in Illinois—A Closer Look,* August/September 2020, p. 10.

APPENDIX A: CURRENT CONSTITUTIONAL PROVISION AND PROPOSED AMENDMENT

On November 3, 2020, Illinois voters are being asked whether to change the provision in Title IX of the Illinois Constitution that currently requires a flat income tax. The current provision and proposed amendment are shown below.

SECTION 3. LIMITATIONS ON INCOME TAXATION (CURRENT)[85]

(a) A tax on or measured by income shall be at a non-graduated rate. At any one time there may be no more than one such tax imposed by the State for State purposes on individuals and one such tax so imposed on corporations. In any such tax imposed upon corporations the rate shall not exceed the rate imposed on individuals by more than a ratio of 8 to 5.

SECTION 3. LIMITATIONS ON INCOME TAXATION (PROPOSED)[86]

(a) The General Assembly shall provide by law for the rate or rates of any tax on or measured by income imposed by the State. In any such tax imposed upon corporations the highest rate shall not exceed the highest rate imposed on individuals by more than a ratio of 8 to 5.

[85] Ill. Const. art. IX, sec. 3(a), https://www.ilga.gov/commission/lrb/con9.htm.
[86] Illinois Secretary of State, *Proposed Amendment to the Illinois Constitution*, p. 1, https://www.cyberdriveillinois.com/publications/con_amend/ca_english.pdf.