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Grappling With Graduated Income Taxes

Let's decode the math behind proposed graduated income tax plans.

Keith Staats, JD

Executive Director, Illinois Chamber Tax Institute

Deciphering Today's State & Federal Tax Law

The Illinois Constitution currently forbids the imposition of a graduated income tax, but calls for constitutional amendments authorizing one continue to come forward in the Illinois General Assembly. The opportunity for inclusion on the November 2018 ballot has expired but, depending on the Illinois General Assembly's composition following the November election, we could see such an amendment on the 2020 ballot.

Proposed constitutional amendments authorizing a vote on a graduated income tax on individuals and corporations were introduced in the General Assembly over the past two years but lacked the support needed to advance. Non-binding resolutions, from both sides of the aisle and both sides of the issue, were filed during the spring. HR 975, sponsored by Republican Leader Jim Durkin and most House Republicans, opposes a graduated income tax. HR 1025, sponsored by Speaker Mike Madigan and most House Democrats, urges a "progressive" (graduated) income tax.

The House Revenue Committee even held a subject matter hearing in Chicago on May 2 to hear testimony from HR 1025 proponents and opponents. In full disclosure, I testified on behalf of the Illinois Chamber of Commerce, expressing our opposition. Although I have strong feelings on the issue, I'm not writing this column to argue for or against a graduated income tax — I want to decode the numbers.

In particular, the Center for Tax and Budget Accountability's (CTBA) recent report, "Cutting Taxes for the Middle Class and Shrinking the Deficit: Moving to a Graduated State Income Tax in Illinois," illustrates the inherent difficulty in imposing a graduated income tax that raises substantial new revenues, without significantly increasing the tax burden on the middle class.

The CTBA, a clear proponent of a graduated income tax, offers two proposals that it claims could raise an additional $2 billion in general funds revenues, while providing a tax cut to 98 percent of taxpayers. While that sounds enticing at the surface level, let's look at the numbers.

The first proposal recommends leaving the current tax rate of 4.95 percent in effect for all taxpayers earning less than $300,000 in taxable income. Those with taxable income over $300,000 would see their rates balloon to 7.5 to 9.85 percent. The "tax cut" for 98 percent of taxpayers is in the form of a $300 tax credit for those earning less than $100,000 (single) or $200,000 (jointly) in taxable income. In other words, a tax reduction of about $11.50 per paycheck for employees paid bi-weekly.

The second proposal would reduce the tax rate to 4.5 percent on taxable income up to $100,000, maintain 4.95 percent on taxable income from $100,000 to $300,000, and raise rates to 8 to 9.85 percent on higher taxable income levels. Again, the tax cut under this proposal is also minimal — $225 for someone earning $50,000.

Now, the $2 billion revenue increase projected in these proposals is close to what some have indicated is the current state budget structural deficit. However, many proponents of a graduated income tax are not proposing the tax just to close the perceived structural deficit — they're seeking additional funding for programs they contend are inadequately funded. Therefore, assuming there's no political will to cut state spending, the CTBA numbers demonstrate that obtaining significant amounts of new revenue over and above $2 billion would require raising the current 4.95 percent income tax rate on taxpayers earning less than $300,000 in taxable income. Regardless of your judgment on the programs seeking additional funding, the fact of the math is there just aren't enough "rich" people to tax at higher rates under a graduated income tax to provide all the additional revenues.

The CTBA proposals would impose a graduated rate structure only on individuals, but recently proposed constitutional amendments to authorize a graduated income tax would also authorize a graduated rate on corporations. If revenues from a graduated rate structure on individuals prove to be inadequate for those who seek additional tax revenues, they will likely turn to graduated rates on corporations.

One rationale behind the call for a graduated rate structure, in addition to the "fairness" argument, is that the tax base has been eroded because of "corporate loopholes" that need to be closed. Let's review that assertion. Over the years, there has been significant tax base erosion via enactment of exemptions, credits, and deductions. However, the tax base erosion stems overwhelmingly from exemptions, credits, and deductions provided to individual taxpayers — not to corporations. The two biggest exemptions are the $1.8 billion exemption for federally taxed retirement income and $1.98 billion state sales tax exemption for food and drugs. In contrast, the Economic Development for a Growing Economy (EDGE) Tax Credit and Research and Development Tax Credit provided $82.4 million and $27.2 million in tax relief to corporations. Those are FY 2016 figures; with the tax rate reinstated to 4.95 percent, it's estimated that the retirement income exemption will increase to approximately $2.7 billion for the current fiscal year. Again, I'm not making a judgment as to the value of the exemptions and credits, but the numbers demonstrate where tax base erosion has occurred most.

Further, even in the face of the state's budget crisis, the General Assembly enacted additional individual tax credits, including the Invest in Kids Scholarship Tax Credit Program ($75 million), a new Natural Disaster Income Tax Credit, a new tax credit allowing teachers to claim up to $250 in deductions for supplies, and an increase to the Education Expense Credit.

In my estimation, the proponents of graduated income tax rates are mistaken if they think they can solve state spending imbalances without taxing the middle class. It's equally unrealistic for opponents to such a plan to argue that taxes can be reduced if only cuts are made. There's no political will among current members of the General Assembly to make those kinds of spending cuts or tax rate changes.

And, despite rhetoric from candidates of both political parties, nobody, once in office, seems to be able to discover and eliminate enough “waste, fraud, and abuse” to make material changes to the spending side of the state’s ledger.

The Illinois General Assembly and the governor will continue to have difficult budget choices ahead. There will be continued discussions about changing the state’s tax structure to capture additional revenues. As the CTBA states: “No silver bullet exists that will entirely resolve all these challenges.” It’s essential to get beyond the rhetoric of both sides and carefully evaluate the numbers.

Author’s Note: This column includes my personal observations and are not necessarily the views of the Illinois CPA Society or the Illinois Chamber of Commerce.