Will the Last Taxpayer in Illinois Please Turn Out the Lights:

An Economic Assessment of the Illinois "Fair Tax"

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Executive Summary

This study examines the proposed constitutional amendment that would change the Illinois state income tax from a flat tax to a graduated income tax. Passage of the constitutional amendment would lead to the enactment of Illinois Senate Bill 687, which would raise personal and corporate income tax rates. The highest personal income tax rate would rise by more than 60% - from 4.95% to 7.99%. This would be one of the largest tax increases on small and large businesses of any state in at least two decades.

In this study, we examine how similar tax changes over the past 60 years have affected economic performance in other states. We also examine Illinois' current economic performance and analyze the effect these proposed tax changes will have on the state's future performance. Finally, we provide econometric projections to quantify the economic impact of the proposed constitutional amendment. We provide a range of estimates on job losses, outmigration, lost production, lost state income, and home value appreciation.

We find that the Illinois "Allow for Graduated Income Tax Amendment" will have significant negative effects on the state's economy and its citizens.

Passage of Illinois Senate Joint Resolution Constitutional Amendment 1, in conjunction with Senate Bill 687, would introduce the following tax changes:

- Increases the top personal income tax rate from 4.95% to 7.99%.
- Sets the top tax bracket at $750,000 for individuals and $1 million for joint filers.
- For the top bracket, the top rate of 7.99% applies to <u>all</u> income (not just income above $750,000/$1,000,000).
- Filers with taxable income below $750,000/$1,000,000 are subject to a graduated tax schedule with a top rate of 7.85%.[1]
- Increases the top net corporate income tax rate from 9.5% to 10.49%.
- A tax amnesty program for evaders of all franchise tax and license fees.

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[1] Because of the switch to a flat tax after $750k, there is a cliff effect: Filers making $750k pay $51,460 in state tax; filers making 750,001 pay $60,005 – a difference of $8,545.

- A phase out and repeal of the Illinois Franchise tax by January 1, 2024.

If Constitutional Amendment 1 is passed:

- Job growth would slow by an estimated 566,000 over the next 10 years – effectively eliminating about one in ten current jobs.
- Net migration to Illinois (people from other states moving TO Illinois minus the number of people moving OUT of Illinois would be negative 1.4 million fewer residents over the next decade due to the tax. The outmigration from Illinois would rise about 9 times faster than its current rate.
- Personal income would grow by $19.2 billion less over the next 10 years.
- Illinois' Gross State Product (GSP) would grow by $20.5 billion less over the next decade.
- Illinois' tax revenues would increase, but far less than the projected $3.6 billion in new tax revenues. In the decade following the enactment of the progressive tax, additional revenues would be just 39% of the projected $3.6 billion, or roughly $1.4 billion.
- Illinois' economic competitive position among the 50 states would fall from 47th in the nation to 49th in the widely acclaimed ALEC-Laffer competitiveness index. Illinois would move from having the 18th lowest personal income tax rate in the nation to the 9th highest.
- Home value appreciation would be 10.4 percent less over a decade due to much lower home-buying residents in the state.
- Successful Illinois small businesses would be severely adversely impacted by the tax because most small businesses pay tax through the personal income tax, not the corporate tax. Federal studies show that more than half of taxes on those filers with incomes above $500,000 in income are small business owners and investors. A Small Business Administration study finds that well over half of all jobs come from small businesses.
- The corporate tax increase will make Illinois one of the five highest tax jurisdictions in the entire world. Only New Jersey and a handful of third world nations would have a higher tax on corporations. Corporate headquarters would move away from Chicago and the entire state of Illinois.

Figures 1, 2, and 3 show the further erosion of Illinois' competitiveness if the Pritzker tax were to pass. Illinois already has one of the highest sales and property taxes in the nation. Only New Jersey would have a higher corporate tax rate. Only five states would have higher rates on pass-through income, and only eight states would have higher rates on nonbusiness income.

Figure 1
Top Marginal Corporate Tax Rates by State, 2021

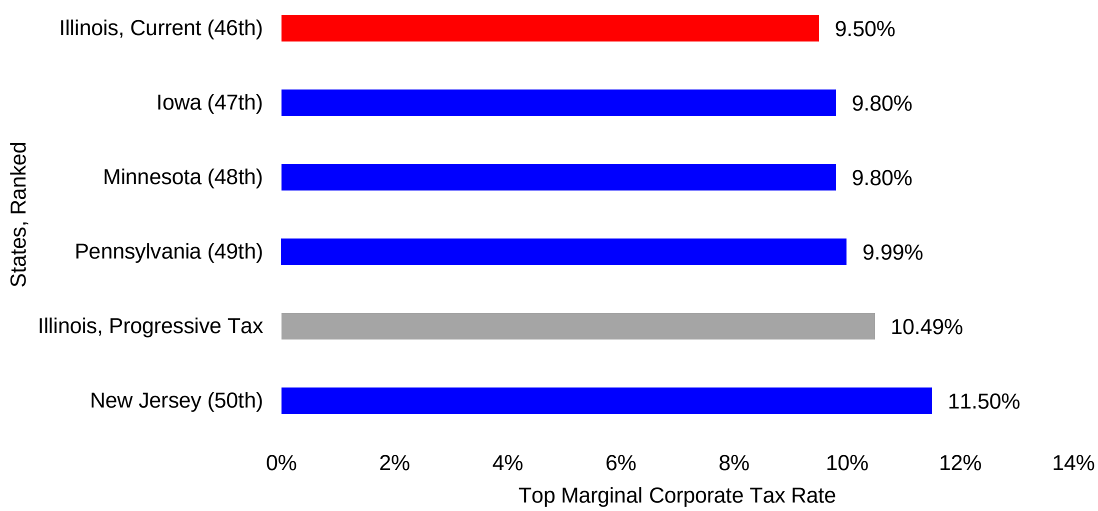


Figure 2
Small Business Tax Rate, 2021

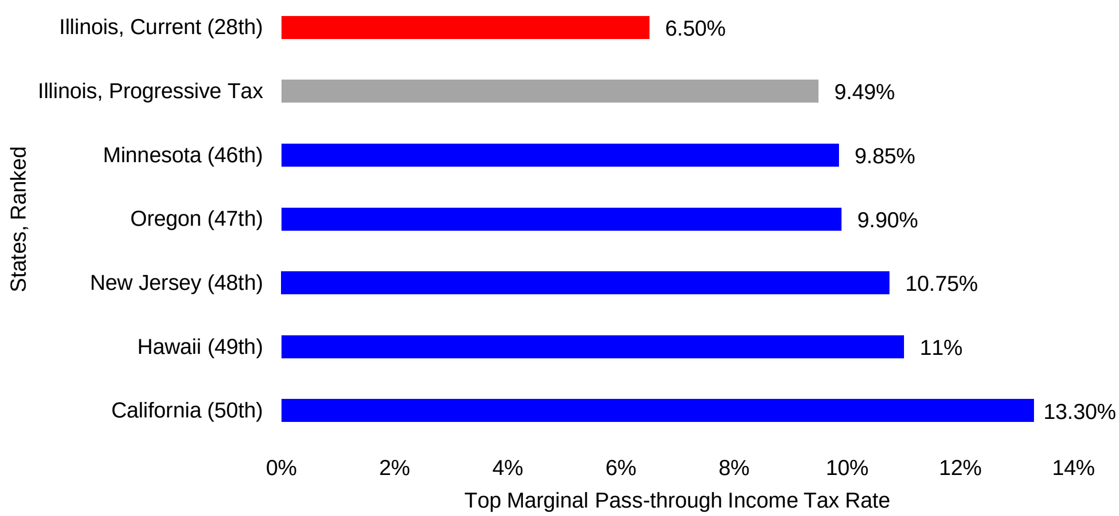
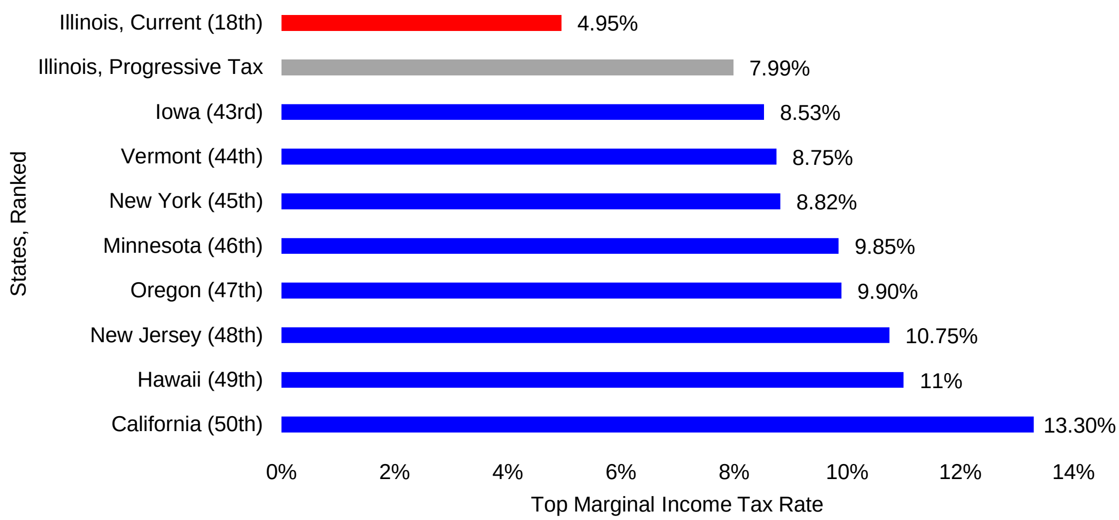


Figure 3
Top Marginal Income Tax Rate by State, 2021



We also believe that this is the WORST possible time to be raising income tax rates on small businesses for two reasons. First, although Governor Pritzker says the tax will only negatively affect millionaires and billionaires, the tax hits small businesses with profits as low as $250,000. Small firms – stores, shops, restaurants - have been negatively impacted by the COVID shutdowns in Illinois. To raise taxes at the very time they are getting back in operation will inhibit the recovery.

Second, the federal tax law changes in 2017 capped the deduction of state and local taxes (SALT) from federal tax liabilities at $10,000. This means most wealthy Americans, especially in high-tax states like Illinois, will no longer be able to write off some 40% of their state (and local) taxes from federal taxes. Hence, now all the burden from the higher tax rates falls on the shoulders of the state taxpayers – which makes high state tax rates much more burdensome on residents of high-tax states like California, New Jersey, New York, and Illinois.

Pritzker's Proposed Tax Changes

On November 3, 2020, Illinois voters will vote on a proposed amendment to the 1970 Illinois Constitution. Illinois Senate Joint Resolution Constitutional Amendment 1, also known as the "Allow for Graduated Income Tax Amendment," would allow the Illinois state income tax code to transition from a flat tax to a graduated income tax. To pass, it requires a "yes" vote from 60% of the votes on the amendment itself, or a "yes" vote on a simple majority of all ballots submitted for the general election.

In 2019, the Illinois legislature introduced and approved a resolution that would place the "Allow for Graduated Income Tax Amendment" up for a vote during the November 2020 election. The Illinois state legislature subsequently passed Senate Bill 687, referred to as the "Illinois Fair Tax," which would alter the structure of Illinois' income tax brackets should voters approve the amendment.

Constitutional Amendment 1 would amend Section 3(a) of Article IX of the Illinois Constitution. The following strike-through text would be removed from the Constitution and the underlined text would be added to the Constitution:

> "*The General Assembly shall provide by law for the rate or rates of any tax on or measured by income imposed by the State.* ~~*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 highest rate shall not exceed the highest rate imposed on individuals by more than a ratio of 8 to 5.*"

Senate Bill 687 would eliminate Illinois' current 4.95% flat rate personal income tax on all incomes and institute graduated income tax rates for individual and joint filers as follows:

Table 1
Illinois' Proposed Personal Income Tax Rates
(effective January 1, 2021 pending the passage of Constitutional Amendment 1)

Individual Filers		Joint Filers	
Marginal Tax Rate	Net Income	Marginal Tax Rate	Net Income
4.75%	$0-$10,000	4.75%	$0-$10,000
4.90%	$10,001-$100,000	4.90%	$10,001-$100,000
4.95%	$100,001-$250,000	4.95%	$100,001-$250,000
7.75%	$250,001-$350,000	7.75%	$250,001-$500,000
7.85%	$350,001-$750,000	7.85%	$500,001-$1,000,000
7.99% (applied to total income)	>$750,000	7.99% (applied to total income)	>$1,000,000

Corporate income taxes will also increase under Senate Bill 687. The corporate income tax rate in the state of Illinois currently stands at a flat 7% rate. The state constitution prohibits this rate from exceeding the personal income tax rate by a ratio of 8 to 5, so under the current 4.95% personal income tax rate, the corporate income tax rate is capped at 7.92%. Illinois also collects a 2.5% Personal Property Replacement Tax (PPRT) created in 1976 to fund local governments. This surcharge brings the total corporate income tax rate to 9.5%. The PPRT is levied in addition to the corporate income tax and is not subject to the tax rate ceiling calculated using the 8 to 5 ratio.

Senate Bill 687 raises the corporate income tax rate from 7% to 7.99%, or from 9.5% to 10.49% taking the PPRT into account. This rate hike on its own creates harsh negative externalities for Illinois; however, what is more ominous is the language of Senate Joint Resolution 1, the question on the ballot this fall. The Illinois Constitution prevents the corporate income tax rate from exceeding the personal income tax rate by more than an 8 to 5 ratio, but if the state adopts a graduated income tax, the constitution must specify the rate used to calculate a ceiling on corporate income tax rates. SJR 1 tethers the *highest* personal income tax rate to the maximum corporate income tax rate. At a ratio of 8 to 5, this places the ceiling of the corporate income tax rate at 12.78%, or a whopping 15.28% taking the PPRT into account. Upon passage of this amendment, the Illinois General Assembly will be able to raise rates to this level, with the same process as any other state bill, needing only to pass both chambers of the state assembly and a signature from the governor.

Following the passing of the upcoming ballot measure, Illinois would move from holding the 5th highest state corporate income tax rate to the 4th highest, but this assumes other state rates hold constant. Iowa, which taxes corporate income at a 12% tax rate, will be lowering their highest rate to 9.8% beginning in 2021,[2] moving the new Illinois corporate rate to 2nd highest in the nation. The suggested new Illinois corporate income tax rate of 10.49% would only be surpassed by New Jersey, at 10.5%.

Illinois employers are reasonably apprehensive regarding higher income tax rates if SJR 1 is passed by the voters. The elevated constitutional ceiling for the corporate income tax rate is also a potential threat to future business and will deter firms from coming to Chicago or the rest of the state.

The tax structure imposed by Senate Bill 687 includes several atypical and undesirable provisions that will create problems for Illinoisans. Tax rates are typically marginal, meaning that only incomes above a certain threshold are taxed at a higher rate. For example, using the tax rates presented in Table 1, an Illinoisan with $50,000 taxable income would be taxed at 4.75% for the first $10,000 of their income and taxed at 4.90% on the remaining $40,000 of their taxable income. However, for income earners in the highest tax bracket (taxable income greater than $750,000 for an individual filer or $1,000,000 for joint filers), Senate Bill 687 imposes a flat 7.99% tax rate that is applied to <u>all</u> income, not just income above $750,000/$1,000,000 (individual/joint). This corresponds to an additional $8,545/$8,965 (individual/joint) in tax burden for those with taxable incomes in the highest tax bracket. This creates a tax cliff, where a higher taxable income can result in less after-tax income. Under such a tax system, any Illinoisan with taxable income greater than $740,815 and not more than $750,000 would actually take home more after taxes than would an Illinoisan with taxable income of $750,001.

[2] https://taxfoundation.org/state-corporate-rates-brackets-2019/

“Bracket creep” is another undesirable issue introduced by the “Fair Tax.” The proposed tax brackets are not indexed for inflation, meaning that as incomes rise due to inflation, the income tax brackets will remain constant. As a result, Illinois taxpayers will pay an ever-increasing share of their personal incomes in taxes, despite not actually experiencing income growth in real terms.

The tax brackets imposed by Senate Bill 687 are also disadvantageous for joint filers (sometimes called a “marriage penalty”). The income thresholds imposed on joint filers only vary slightly from the thresholds imposed on individual filers, meaning that two earners would owe more taxes filing jointly than they would if they filed individually. As an example, take a household with two income earners, each making $250,000 in taxable income. Filing separately, each individual would owe $12,310 in income taxes, or $24,620 total. However, when filing jointly, the second earner’s full $250,000 income would be taxed at 7.75%, leading to a total tax bill of $31,685, a $7,065 increase in income tax burden just for filing jointly.

Illinois Is Already a Very-High-Tax State

Table 2 shows how tax rates in Illinois today rank compared to how tax rates will rank if the Pritzker tax were to pass. Illinois is already an extremely high property tax, sales, tax, and corporate income tax state – without the Prizker tax scheme.

Table 2

Where Does Illinois Rank Before and After the Progressive Tax?

Category	Current	Pritzker’s Progressive Tax
Top Personal Marginal Income Tax Rate	18th	42nd
Top Corporate Marginal Income Tax Rate	46th	49th
Sales Tax Burden	45th	45th
Property Tax Burden	49th	49th
Credit Rating	50th	50th
Domestic Migration, Percentage	49th	50th
Gasoline Tax Rate	48th	48th
“Rainy Day” Fund	50th	50th
Public Pension Funding Ratio	48th	48th
Overall Tax Burden	47th	48th
State and Local Debt per Capita	46th	46th
ALEC-Laffer Competitiveness	47th	49th

Despite increases in state tax receipts over the years, spending increases in Illinois have outpaced revenue growth. In fact, Illinois has already raised income taxes twice in the last decade. The publication *Rich States, Poor States* places Illinois in the 48th worst spot among all 50 states for economic outlook, due in large part to its high total tax burden.

Those with higher incomes have more to lose from higher tax rates and they simultaneous have, on average, more disposable income, making it easier to move. While Illinois is losing residents from every income bracket, those with annual earnings of $200,000 or more are leaving the state at about twice the rate of the average Illinoisan.[3] This effect has only been exacerbated by tax reform that capped the SALT deduction at $10,000. Since the passage of the Tax Cuts and Jobs act of 2017, the effect of the top marginal personal income tax rate on domestic migration has increased by 74%. The cap on SALT deductions dictates that Illinois' residents will feel the full brunt of the tax increase, amplifying the effects. This means that high state income tax rates are much more harmful to the state's people and economy, and the results are outmigration and fewer jobs.

From 2014 to 2019, Illinois had a net loss of population every year, for six years, with a net loss for the decade. It was the largest decline of any state and only West Virginia saw a larger percentage-based decline. Pennsylvania, consequently, has supplanted Illinois as the fifth most populous state.[4] Illinois will lose a minimum of one seat in Congress as a result.

The United Van Lines survey provides anecdotal evidence to Census data and confirms that Illinois is among the leaders of outmigration and has been for years.[5] Taxes are often cited by those surveyed as the reason for leaving. Some claim that people are just moving to warmer climates, and there may be some evidence for that, such as those who move from Illinois to Florida, but that fails to explain why Illinois is experiencing annual net losses of population to all five of its neighboring states, including Wisconsin which is further north. Mass departure has become so pronounced that Illinois has had roughly as many people moving away as dying.

Despite numerous tax increases resulting in one of the nation's highest overall tax burdens, Illinois cannot balance a budget. The state last had a balanced budget in 2001. In 2017, the budget deficit was over seven and a half billion dollars. While spending has grown, so have the unpaid bills; Illinois has amassed a bill backlog of over $7 billion. The unfunded pension liability situation is even worse. Illinois had more than $130 billion in unfunded pension liabilities in 2019. The General Assembly Retirement System is about 85% unfunded.[6] The state's massive debt problem is so bad that Illinois has the lowest investment grade credit rating (one notch above junk) and a negative outlook from all three major NRSROs, indicating it will likely be the first and only state to eventually be downgraded to sub-investment grade. (S&P in particular has cast doubts on the ability of the progressive tax to raise the predicted revenue, indicated that even the progressive tax's passage will not save Illinois from the infamy of being a junk-bond issuer.) As time has gone

[3] Internal Revenue Service, https://www.irs.gov/statistics/soi-tax-stats-migration-data.
[4] U.S. Census Bureau, https://www.census.gov/data/datasets/time-series/demo/popest/2010s-state-total.html
[5] United Van Lines https://www.unitedvanlines.com/newsroom/movers-study-2019.
[6] https://cgfa.ilga.gov/Upload/1117revenue_special_pension_briefing.pdf

by, it has becoming increasingly clear to NRSROs and investors alike that the only way out for Illinois will be default if the state does not cut spending, and fast.

Faced with skyrocketing yield demands from investors earlier this year, Illinois was the first in line to borrow from the new Municipal Liquidity Facility (MLF) at the Federal Reserve, selling $1.2 billion in bonds to the Central Bank. To date, Illinois remains the only state to utilize the Lender of Last Resort, and the Land of Lincoln is now poised to borrow nearly another $5 billion, for two reasons. First, a federal bailout, upon which the Illinois budget is explicitly relying, is highly unlikely at this point. Second, municipal bond investors are highly likely to again punish Illinois with the same yields those investors demanded in May, north of 5.8%, or even higher. A slightly lower rate at the Fed's MLF is the only alternative.

The mishandling of Illinois' finances has had devastating effects for the state's residence beyond outmigration and mounting debt. Poor policy decisions have created an environment in which Illinois has lagged behind the nation. From 2010 through 2019, only in November of 2010 did Illinois' unemployment rate fall below the national average. For the other 119 months of the decade, Illinois underperformed compared to the national at large.[7] Even years before 2010, Illinois had a higher unemployment rate than the national average.

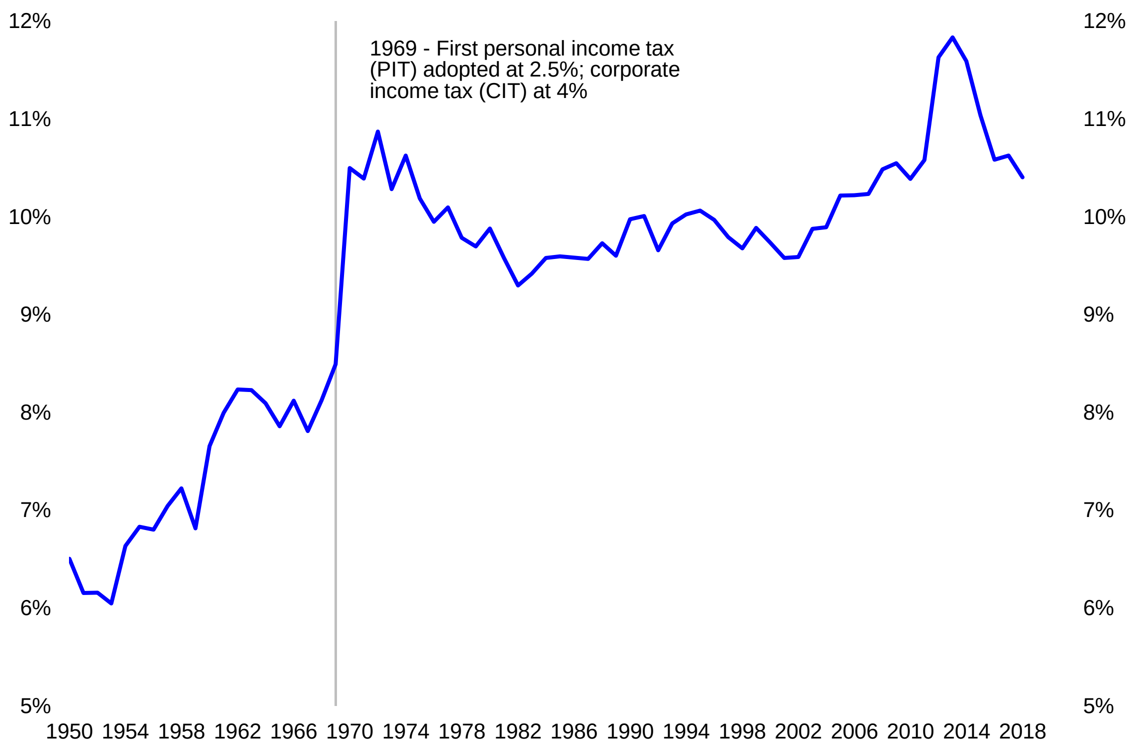
The condition of Illinois' housing market is another indicator of how the state has trailed the rest of the nation. In July 2020, the most recent data point available for Chicago's home price index, the index was 145.6, which is still less than it was almost 16 years ago in October of 2004 when it was 146.2, and July's value this year was 15% below the March 2007 high of 171.3.[8] In 2018, Chicago had more "underwater" mortgages than any other metro area in the country.[9] The anemic housing recovery in Illinois has been driven by the state's tax policy, both directly and indirectly. While taxes, especially property taxes, leave a resident with less money to afford housing, high tax levels have also driven people out of the state, keeping down the demand for housing and indirectly putting downward pressure on home prices.

[7] U.S. Bureau of Labor Statistics, Unemployment Rate in Illinois [ILUR], retrieved from FRED, Federal Reserve Bank of St. Louis
U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis.
[8] S&P Dow Jones Indices LLC, S&P/Case-Shiller IL-Chicago Home Price Index [CHXRSA], retrieved from FRED, Federal Reserve Bank of St. Louis
[9] https://www.chicagotribune.com/real-estate/ct-re-chicago-underwater-mortgages-20180603-story.html

Illinois' Inglorious Tax History

Illinois is already an exceedingly high tax jurisdiction and the steady rise in Illinois tax burdens has played a major role in the state's economic decline. Prior to 1969, Illinois had no income tax even though several states had adopted an income tax during the first half of the 20th century. The Illinois government, like other tax-increasing governments, wanted an income tax, but was blocked by a 1932 Illinois Supreme Court decision that ruled an income tax was unconstitutional.[10] By 1969, this hurdle was overcome (Figure 4).

Figure 4
Illinois State and Local Tax Revenues[11] as a Share of Personal Income
(annual, 1950-2018)



Source: U.S. Census Bureau, Bureau of Economic Analysis

From 1954 through 1962, state and local taxes in Illinois rose substantially even without an income tax. The primary contributors to Illinois' ever-increasing tax burden were mostly increases and changes to the sales tax code. In 1955, Illinois adopted a use tax to recoup lost sales tax revenues from out-of-state shoppers. Alas, once 1969 rolled around, the new income tax became a breakthrough event for tax increases.

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

[11] Data points from 1950-52 and 1954-56 were interpolated due to an incomplete dataset.

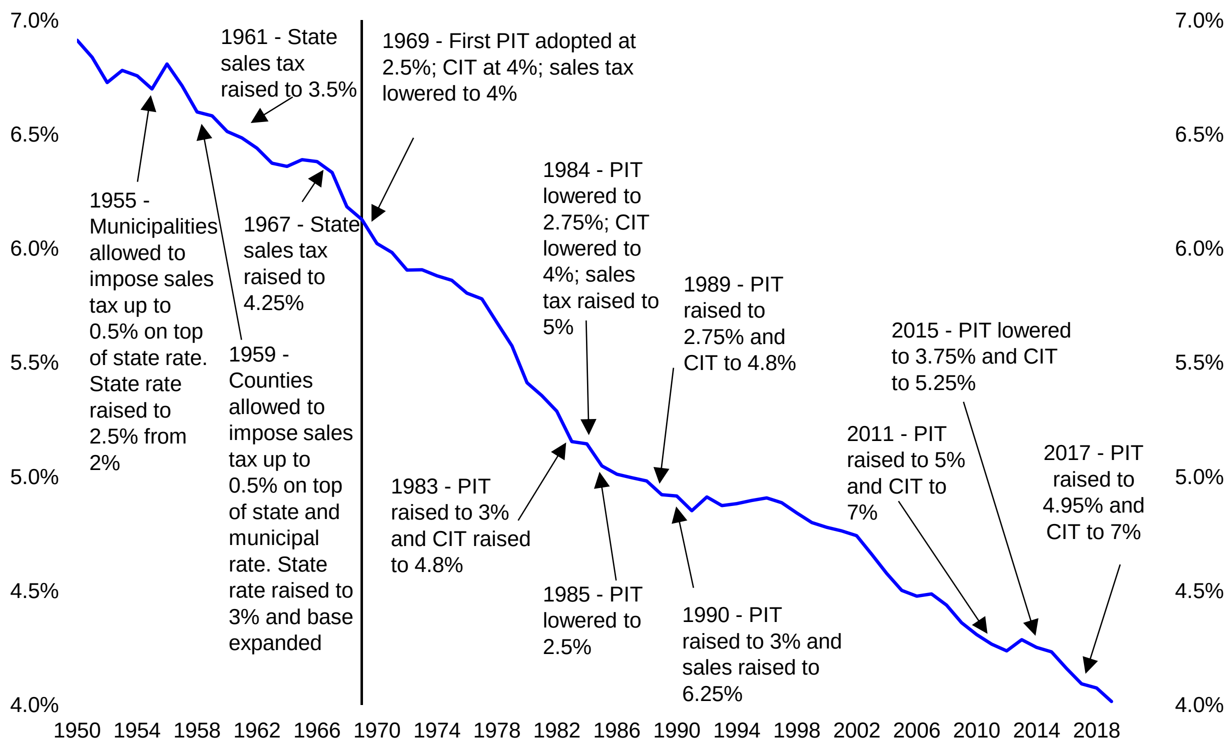
On July 1, 1969, more than 50 years ago, then-Republican Gov. Richard Ogilvie signed into law a 2.5 percent flat rate tax on personal income, as well as a 4 percent tax rate on corporate income. Figure 4 shows all tax revenues collected by Illinois' state and local governments as a share of the state's personal income from 1950 to the present. Without context, Figure 4 may seem like a big win for those advocating income taxes. But remember from the Laffer Curve, there are two effects higher tax rates have: i.) more tax revenue per dollar of tax base and, ii.) a smaller tax base.

Sometimes it takes a little time for supply-side responses to take hold. And in the case of Illinois, the Laffer Curve sought its own version of revenge. Figure 4 only tells us that tax revenues increased *relative* to income. What Figure 4 does not show is the damaging impact higher tax rates had on the tax base even before, and definitely after, the new income tax. Figure 5 plots Illinois' personal income relative to U.S. personal income from 1950 to 2019.

Figure 5

Illinois Personal Income as a Share of Total U.S. Personal Income[12]

(annual, 1950-2019)



Source: Bureau of Economic Analysis, Illinois Department of Revenue

As shown in Figure 5, from 1950 through 1969, Illinois declined relative to the rest of the nation by a little less than one percentage point (from 6.9% in 1950 to 6.1% in 1969). In 1969, the Illinois government adopted its first personal income

[12] Figure 5 uses personal income rather than gross state product because personal income data are more readily available.

tax. Unsurprisingly, this plan backfired and left Illinois' residents reeling from the fallout. After all, every tax dollar is a dollar removed from personal income.

In just 16 years, from 1969 to 1985, Illinois personal income went from 6.1 percent of U.S. personal income to 5.0 percent. By 2010, another 25 years, Illinois personal income dropped to 4.3 percent of U.S. personal income. As of 2019, Illinois sits at just 4.0 percent of aggregate American personal income.

Since 1976, amongst all U.S. states, Illinois has the 4^{th} lowest growth in employment, the 10^{th} worst growth in GSP, the 5^{th} worst rate of personal income growth and the 6^{th} lowest increase in its labor force. In 2019, Illinois had an average unemployment rate of 4%, ranking 38^{th}, compared to the U.S. 50-state equal-weighted average of 3.6%. As of August 2020, Illinois' unemployment rate is 11%, well above the 8.4% unemployment rate nationally.

The Negative Effects of High Tax Rates

If you want less of something, tax it. We tax smokers to get them to stop smoking. We tax speeders on the freeway to get them to stop speeding. In the same vein, why then would anyone want to tax jobs, employment and output? Of course, we tax jobs, employment and output to generate revenue to provide government services rather than to discourage jobs, employment and output. But that does not change the fact that taxing income, or anything else for that matter, is a sure-fire way to ensure you get less income.

Many politicians, those from Illinois included, do not realize that policies shape the economic environment and affect population and income growth, and thus tax revenue growth. Taxes impact: i.) the size of the tax base (income), ii.) the composition of income, iii.) the location of income and, iv.) the timing of income. Taxes tell people what not to do and welfare tells people what to do. Illinois' government has effectively been advertising their state as a place that taxes work, output and employment, and subsidizes non-work, leisure and unemployment. Illinois has been doing this for an awfully long time. Naturally, the market responded.

While some refute the proposition that there are substantial negative effects on migration and a state economy from higher tax rates, our book "The Wealth of States" cites more than 100 academic studies in prestigious economic journals, which, on balance, validate these adverse consequences.[13] Higher tax rates at the local, state and national level are deleterious to growth in a jurisdiction's incomes, population and jobs.

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[13] Laffer, Moore, Sinquefield, and Brown, An Inquiry into the Nature and Causes of the Wealth of States, Wiley, 2014.

<u>The Lessons of Other States Can Predict the Future</u>

History shows that income taxes, more than sales or property taxes[14] - have a large detrimental effect on economic growth and prosperity. The effects are universally felt. Table 3 contains a comparison of each of the 11 states (including Illinois) that adopted an income tax after 1960 with the other 39 states. Since 1964 (five years before Illinois adopted a personal income tax), Illinois' share of the U.S. population relative to the other 39 states fell by 38.5%; GSP share fell by 45.7%; and state and local tax revenue share dropped by 37.4%. And Illinois is not unique in suffering from the adoption of an income tax. Every one of the other ten states had a similar experience.

Table 3

The 11 States That Introduced an Income Tax Since 1961

				Share of Remaining 39 States								
		Maximum Tax Rate		Population			GSP			Total State and Local Revenue		
	First Year of the Tax	Initial	Current	5 Years Before	2019	% Change	5 Years Before	2019	% Change	5 Years Before	2017	% Change
Connecticut	1991	1.50%	6.99%	1.8%	1.4%	-22.8%	2.4%	1.7%	-27.5%	2.4%	1.6%	-31.2%
New Jersey	1976	2.50%	10.75%	4.9%	3.5%	-29.5%	5.4%	3.8%	-28.9%	5.4%	3.8%	-29.4%
Ohio	1972	3.50%	4.80%	7.6%	4.6%	-39.6%	8.0%	4.2%	-47.8%	6.1%	4.6%	-24.0%
Rhode Island	1971	5.25%	5.99%	0.7%	0.4%	-38.9%	0.6%	0.4%	-41.8%	0.7%	0.4%	-35.6%
Pennsylvania	1971	2.30%	3.07%	8.5%	5.0%	-41.0%	8.5%	4.9%	-42.6%	7.7%	4.9%	-36.3%
Maine	1969	6.00%	7.15%	0.7%	0.5%	-28.8%	0.6%	0.4%	-29.7%	0.6%	0.5%	-21.6%
Illinois	1969	2.50%	4.95%	8.1%	5.0%	-38.5%	9.8%	5.3%	-45.7%	7.8%	4.9%	-37.4%
Nebraska	1968	2.60%	6.84%	1.1%	0.8%	-31.1%	1.0%	0.8%	-24.0%	0.9%	0.8%	-14.0%
Michigan	1967	2.00%	4.25%	6.3%	3.9%	-38.1%	7.9%	3.2%	-58.9%	6.6%	3.6%	-45.9%
Indiana	1963	2.00%	3.23%	3.8%	2.6%	-30.5%	3.8%	2.3%	-40.0%	3.4%	2.1%	-38.6%
West Virginia	1961	5.40%	6.50%	1.5%	0.7%	-54.4%	1.2%	0.5%	-60.1%	1.1%	0.7%	-39.5%

Source: BEA, U.S. Census Bureau

Take Connecticut, for example. Connecticut was the most recent state to impose a state level income tax, which occurred in 1991. Five years before imposing the tax, Connecticut was growing like no other and its population was 1.8% of the population of the 39 states not listed in the table above; now Connecticut's population sits at 1.4% of the other 39 states. Similarly, Connecticut's GSP was 2.4% of the 39-state cohort in 1986 and is now down to 1.7%. State and local revenue dropped from 2.4% to 1.6%. The story is the same across the board for Connecticut and every state that made the fatal decision to tax personal income.

[14] It is worth noting the distinction between tax rates and taxes paid. Property tax rates have a much more detrimental impact than income tax rates, but people typically pay far less in property taxes than income taxes because of the large rate differential, hence income taxes have a greater effect. Sales taxes have relatively little effect in either case. Antoni, *Fiscal Triumvirate*, Illinois University Press, 2020.

The similarities between Illinois and Connecticut do not end there. The last state to switch from a flat-rate personal income tax to a progressive personal income tax (as Illinois is poised to do) was Connecticut, which switched tax structures in 1996.

In the 10 years prior to adopting its income tax (1981-1991), Connecticut experienced rapid economic growth. Employment grew by 14.9%, personal income grew by 103.1%, and GSP grew by 122.3%. From 1991-1996 (the years Connecticut imposed a flat rate personal income tax), employment fell by 4.3%, personal income grew by just 26.1%, and GSP grew by 27.2%. In the 10 years following the switch to a graduated personal income tax (1996-2006), Connecticut's economic growth was quite suppressed compared to the pre-tax period of 1981-1991. From 1996-2006, employment growth sat at just 6.3%, personal income grew by 72.1%, and GSP grew by 72.6%. These growth figures all pale in comparison to the booming growth experienced in Connecticut pre-income-tax.

Other studies further corroborate the negative impact that switching to a progressive personal income tax had on the Connecticut economy. As pointed out by the *Illinois Policy Institute*, switching from a flat tax to a progressive income tax significantly impaired the growth in housing values in Connecticut:

> *" A decade after the tax hikes, housing prices had appreciated 46% less when compared to similar nearby states such as Massachusetts, Rhode Island and New Jersey. By 2019, the gap was even larger: average housing prices in Connecticut had appreciated by 70% relative to 144% housing appreciation – less than half – the growth in housing values in similar nearby states."*[15]

The negative consequences of higher tax rates impose themselves on all aspects of the economy.

Using past economic data showing the negative effects of rising marginal income tax rates on population growth, employment growth, personal income growth, and GSP growth, we can estimate the effect that the "Fair Tax" will have on Illinois' economy.

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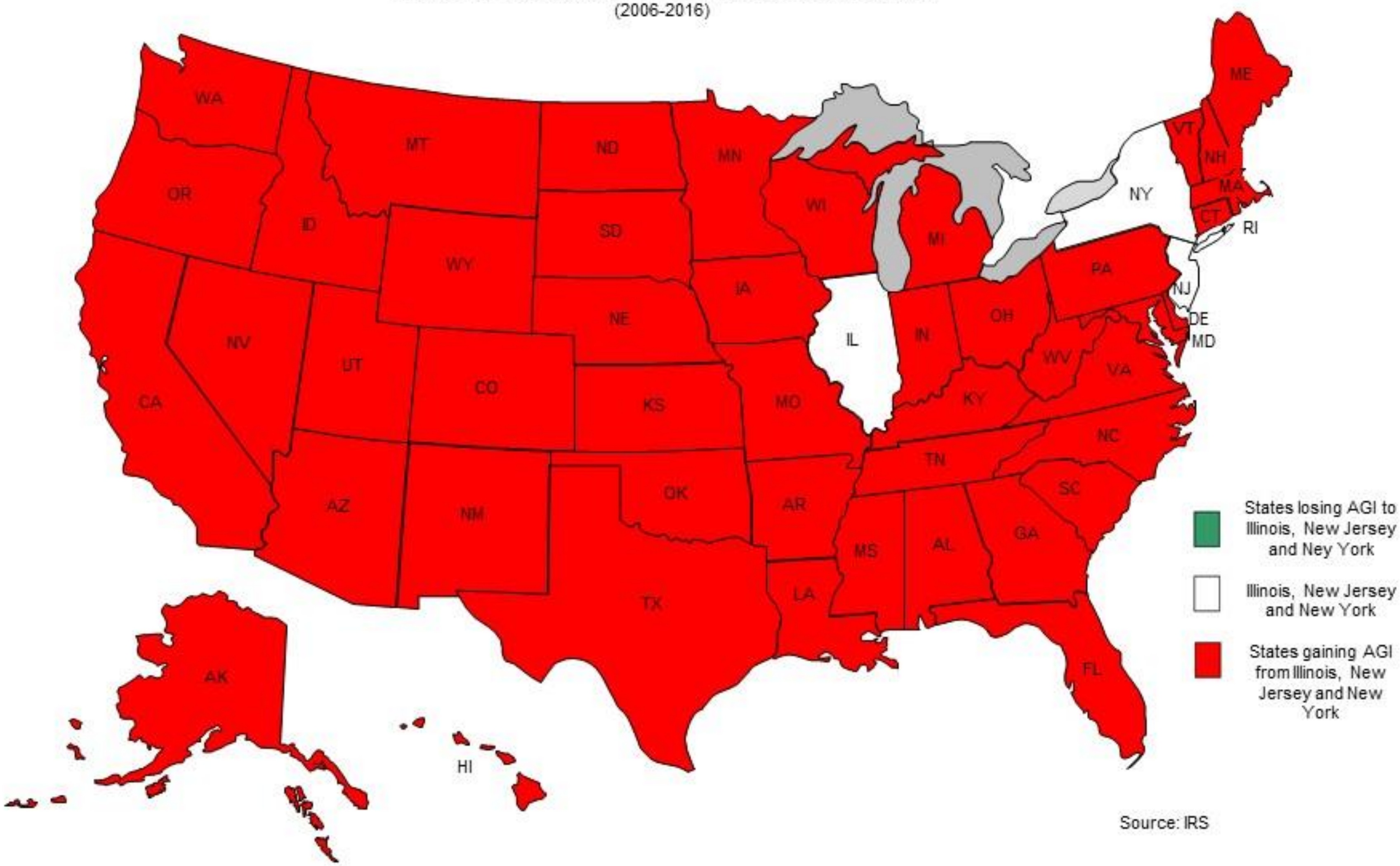
[15] Orphe Divounguy, Bryce Hill, and Jon Josko, "Progressive Tax Could Cost Nearly $1,800 a Year in Home Equity," Illinois Policy Institute.
https://www.illinoispolicy.org/reports/progressive-tax-could-cost-nearly-1800-a-year-in-home-equity/

Income Migration

Figure 6 uses IRS tax return data from 2006-2016 to show the migration of adjusted gross income (AGI) into and out of Illinois, New York and New Jersey (colored white). States where Illinois, New Jersey and New York lost combined AGI are colored red. The trio lost net-AGI to every single state. We predict the passage of Constitutional Amendment 1 will increase the outflow of AGI from Illinois, as high-income earners will have even more incentive to flee the anti-growth policies of Illinois.

Figure 6
Illinois, New Jersey, and New York Aggregate Net-AGI Flow
(2006-2016)



Source: IRS

Green means the state(s) in white had a positive net inflow from the green state. Red means the state(s) in white lost AGI to that state.

Illinois' story is not new. Table 4 uses the same IRS migration data for each state from 1992 to 2016. Each column represents a three-year period and identifies the net amount of AGI that left or entered each state as a share of average AGI filed within that state. Data presented in green represent net in-flows of AGI and data presented in red represent net out-flows of AGI. Over the 24-year period, Illinois languishes at the bottom year in and year out. 12.4% of Illinois' AGI has left the state since the 1992 tax year. Governor Pritzker can expect this capital flight to worsen if his "Fair Tax" is approved.

Table 4

Net In AGI as a % of State AGI Filed (Three-year periods)

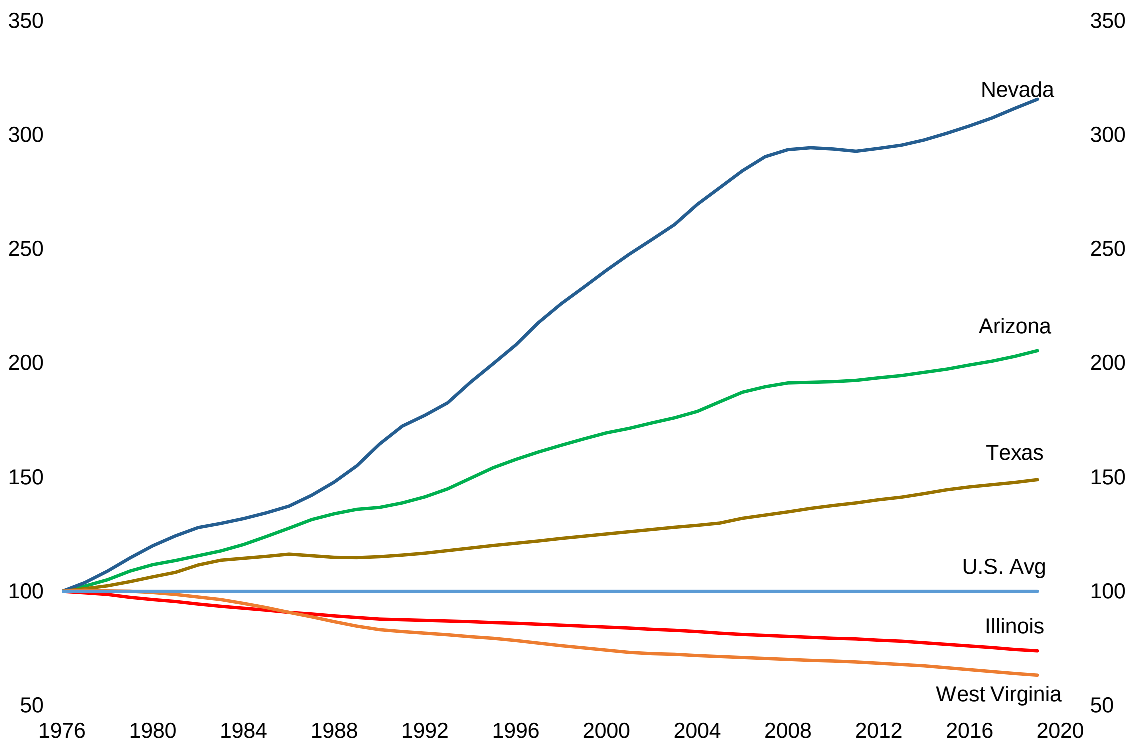
	92-95		95-98		98-01		01-04		04-07		07-10		10-13		13-16	Sum of % of Net AGI Gained (Lost) due to migration from '92/'93 to '15/'16		
NV	11.5%	NV	11.4%	NV	9.7%	NV	9.2%	NV	6.5%	SC	4.2%	FL	4.9%	FL	7.7%	1	NV	30.7%
AZ	8.2%	AZ	6.9%	FL	6.0%	FL	6.9%	AZ	6.2%	MT	3.9%	SC	4.1%	NV	5.4%	2	FL	27.2%
ID	6.2%	FL	5.6%	AZ	5.8%	AZ	5.2%	FL	6.0%	WY	3.2%	NV	3.8%	SC	5.0%	3	AZ	21.7%
CO	5.5%	CO	3.9%	CO	3.6%	MT	3.7%	SC	5.3%	FL	2.9%	WY	3.0%	ID	2.9%	4	SC	20.9%
FL	5.4%	NC	3.6%	NH	3.3%	ID	3.2%	ID	4.8%	NC	2.6%	MT	2.6%	AZ	2.9%	5	ID	15.7%
MT	4.6%	SC	3.4%	ID	3.1%	SC	3.2%	NC	3.9%	AZ	2.4%	ID	2.5%	OR	2.7%	6	MT	14.3%
NC	4.0%	ID	3.2%	SC	3.1%	NH	3.1%	MT	3.2%	NV	2.0%	AZ	2.5%	MT	2.5%	7	NC	13.6%
NM	3.9%	GA	2.9%	WY	2.9%	ME	3.1%	WY	2.9%	CO	2.0%	CO	2.0%	CO	2.3%	8	WY	12.3%
GA	3.9%	OR	2.3%	NC	2.6%	WY	2.6%	OR	2.7%	TX	1.7%	TX	2.0%	NC	2.0%	9	CO	11.6%
OR	3.9%	WY	2.3%	ME	2.4%	NC	1.8%	TN	2.6%	SD	1.6%	NC	1.9%	WY	2.0%	10	OR	9.7%
AR	3.5%	NH	2.3%	VT	2.1%	DE	1.7%	WA	2.3%	TN	1.6%	ND	1.8%	WA	1.9%	11	TN	8.9%
UT	3.2%	WA	2.2%	MT	1.6%	OR	1.4%	CO	2.1%	WA	1.4%	WA	1.4%	TN	1.9%	12	NH	8.2%
TN	2.9%	TN	1.9%	GA	1.5%	VT	1.4%	NM	2.0%	OR	1.4%	HI	1.4%	TX	1.5%	13	WA	7.6%
WA	2.8%	MT	1.9%	DE	0.9%	NM	1.3%	UT	1.8%	ID	1.3%	OR	1.2%	DE	1.3%	14	TX	6.3%
WY	2.5%	VT	1.4%	WA	0.8%	HI	1.3%	AR	1.8%	NM	1.0%	TN	1.1%	UT	1.3%	15	GA	6.2%
SC	2.3%	TX	1.2%	TN	0.8%	TN	1.1%	NH	1.8%	UT	1.0%	ME	0.9%	HI	1.0%	16	ME	5.7%
VT	1.8%	AR	1.1%	OR	0.7%	AR	1.1%	TX	1.8%	DE	1.0%	SD	0.9%	SD	0.7%	17	DE	5.6%
NH	1.8%	ME	0.8%	AR	0.6%	WA	0.8%	GA	1.7%	AL	0.9%	NH	0.7%	NH	0.6%	18	SD	4.3%
SD	1.7%	MS	0.8%	TX	0.6%	GA	0.7%	DE	1.6%	AR	0.8%	UT	0.7%	ME	0.4%	19	AR	4.2%
MS	1.3%	UT	0.7%	VA	0.6%	VA	0.7%	SD	1.4%	GA	0.8%	DE	0.5%	GA	0.4%	20	UT	4.0%
TX	1.2%	AL	0.5%	SD	0.4%	RI	0.7%	AL	1.2%	OK	0.5%	OK	0.3%	AL	-0.3%	21	VT	2.8%
AL	1.0%	KY	0.1%	RI	0.1%	SD	0.6%	VT	0.9%	WV	0.2%	AL	0.2%	AR	-0.3%	22	AL	2.2%
KY	0.7%	DE	0.0%	CA	-0.1%	CO	0.5%	ME	0.7%	KY	0.2%	GA	0.0%	CA	-0.4%	23	NM	1.0%
DE	0.7%	VA	-0.3%	KY	-0.1%	TX	0.4%	KY	0.4%	VT	0.2%	KY	0.0%	OK	-0.5%	24	HI	0.3%
WV	0.5%	OK	-0.3%	MS	-0.1%	AL	0.4%	HI	0.3%	NH	0.2%	AR	-0.2%	ND	-0.7%	25	KY	0.0%
VA	0.5%	MO	-0.3%	WI	-0.3%	WV	0.3%	WV	0.3%	VA	0.1%	CA	-0.4%	MO	-0.8%	26	MS	-0.6%
WI	0.5%	SD	-0.4%	AL	-0.4%	KY	0.2%	OK	0.1%	MS	0.1%	VT	-0.5%	MI	-0.8%	27	OK	-1.4%
IN	0.4%	NM	-0.4%	MA	-0.7%	MS	0.2%	MS	0.0%	ME	0.0%	IA	-0.5%	KY	-0.9%	28	VA	-1.4%
MO	0.3%	IN	-0.5%	MN	-0.7%	WI	0.0%	MO	-0.1%	HI	-0.1%	IN	-0.5%	IN	-0.9%	29	WV	-2.3%
MN	0.3%	WI	-0.5%	MO	-0.8%	PA	-0.4%	VA	-0.4%	LA	-0.2%	MS	-0.6%	IA	-0.9%	30	MO	-2.6%
ME	-0.3%	WV	-0.7%	MD	-0.8%	MO	-0.4%	PA	-0.4%	MO	-0.3%	LA	-0.6%	WI	-1.0%	31	WI	-3.0%
OK	-0.4%	MA	-0.7%	UT	-0.9%	MD	-0.5%	WI	-0.6%	PA	-0.3%	PA	-0.7%	LA	-1.0%	32	IN	-3.8%
KS	-0.6%	KS	-0.8%	IN	-1.0%	UT	-0.6%	IN	-0.7%	IA	-0.3%	VA	-0.7%	VT	-1.1%	33	PA	-4.2%
PA	-0.6%	MN	-0.8%	HI	-1.1%	CT	-0.6%	MN	-0.9%	ND	-0.4%	MO	-0.7%	MA	-1.2%	34	ND	-4.4%
NE	-0.7%	MI	-0.9%	PA	-1.1%	MN	-0.8%	IA	-0.9%	CA	-0.6%	WV	-0.8%	MS	-1.2%	35	CA	-4.4%
MD	-0.8%	CA	-1.0%	MI	-1.2%	OK	-0.9%	KS	-1.0%	IN	-0.7%	WI	-0.8%	MN	-1.2%	36	MN	-4.4%
IA	-0.9%	PA	-1.2%	WV	-1.3%	IN	-0.9%	NE	-1.2%	MA	-0.7%	NE	-0.8%	NE	-1.3%	37	IA	-5.6%
OH	-1.0%	OH	-1.3%	CT	-1.5%	MI	-1.1%	CT	-1.5%	MN	-0.7%	MI	-1.0%	RI	-1.3%	38	MA	-6.3%
MI	-1.0%	IA	-1.5%	OK	-1.6%	CA	-1.1%	AK	-1.6%	WI	-0.8%	NM	-1.0%	WV	-1.3%	39	KS	-6.6%
LA	-1.2%	NE	-1.5%	NJ	-1.7%	LA	-1.1%	ND	-1.8%	KS	-0.9%	MN	-1.0%	PA	-1.4%	40	NE	-6.8%
MA	-1.3%	MD	-1.5%	NM	-1.8%	NJ	-1.2%	MD	-1.8%	NE	-0.9%	MA	-1.1%	KS	-1.4%	41	MD	-7.1%
NJ	-1.6%	LA	-1.6%	OH	-1.9%	IA	-1.4%	CA	-1.9%	MD	-1.0%	KS	-1.1%	OH	-1.5%	42	LA	-7.7%
ND	-1.8%	NJ	-1.8%	KS	-2.0%	NE	-1.4%	IL	-1.9%	AK	-1.1%	OH	-1.4%	NM	-1.5%	43	RI	-8.2%
CT	-1.9%	RI	-1.9%	IA	-2.2%	OH	-1.5%	OH	-2.0%	DC	-1.2%	RI	-1.4%	VA	-1.5%	44	MI	-8.6%
IL	-1.9%	CT	-2.0%	LA	-2.5%	AK	-1.6%	MI	-2.3%	CT	-1.3%	MD	-1.5%	MD	-2.0%	45	OH	-9.0%
HI	-2.1%	IL	-2.3%	IL	-2.5%	KS	-1.6%	NJ	-2.5%	IL	-1.4%	NJ	-1.9%	NY	-2.7%	46	CT	-10.5%
RI	-3.4%	ND	-2.5%	NE	-2.6%	MA	-2.1%	MA	-2.5%	NJ	-1.6%	NY	-2.1%	NJ	-2.8%	47	NJ	-10.5%
CA	-3.5%	HI	-2.9%	NY	-2.8%	IL	-2.2%	RI	-2.8%	OH	-1.7%	IL	-2.4%	AK	-3.0%	48	IL	-12.4%
AK	-3.7%	AK	-3.4%	DC	-3.2%	ND	-2.3%	NY	-3.5%	RI	-2.2%	CT	-2.9%	IL	-3.2%	49	AK	-13.5%
NY	-3.8%	NY	-3.8%	AK	-3.5%	NY	-3.1%	DC	-3.5%	NY	-2.2%	AK	-3.9%	CT	-3.3%	50	NY	-13.8%
DC	-12.1%	DC	-9.8%	ND	-3.8%	DC	-5.9%	LA	-4.2%	MI	-2.8%	DC	-4.4%	DC	-3.9%	51	DC	-19.6%

Illinois' population growth rate of 0.0% since 2008 is ranked 49th in the nation—only besting West Virginia. Over the last ten-year period for which data are available, Illinois also ranked 48th in domestic net migration having lost over 900,000 net residents, which is equivalent to about 7% of their total population in 2010. No matter how you measure it, people are leaving Illinois at rates unmatched by almost every other state. Despite an ever-declining population, Illinois believes that raising the income tax rate will fix all its problems, but you cannot raise tax revenues if there is nobody left to tax. Plotted in Figure 7 are indexed values of the share of U.S. population residing in Illinois and select U.S. states from 1976 to 2019.

Figure 7

Illinois Population as a Share of U.S. versus Select U.S. States

(annual, 1976-2019, semi-log scale, index = 1976)



Source: Bureau of Economic Analysis

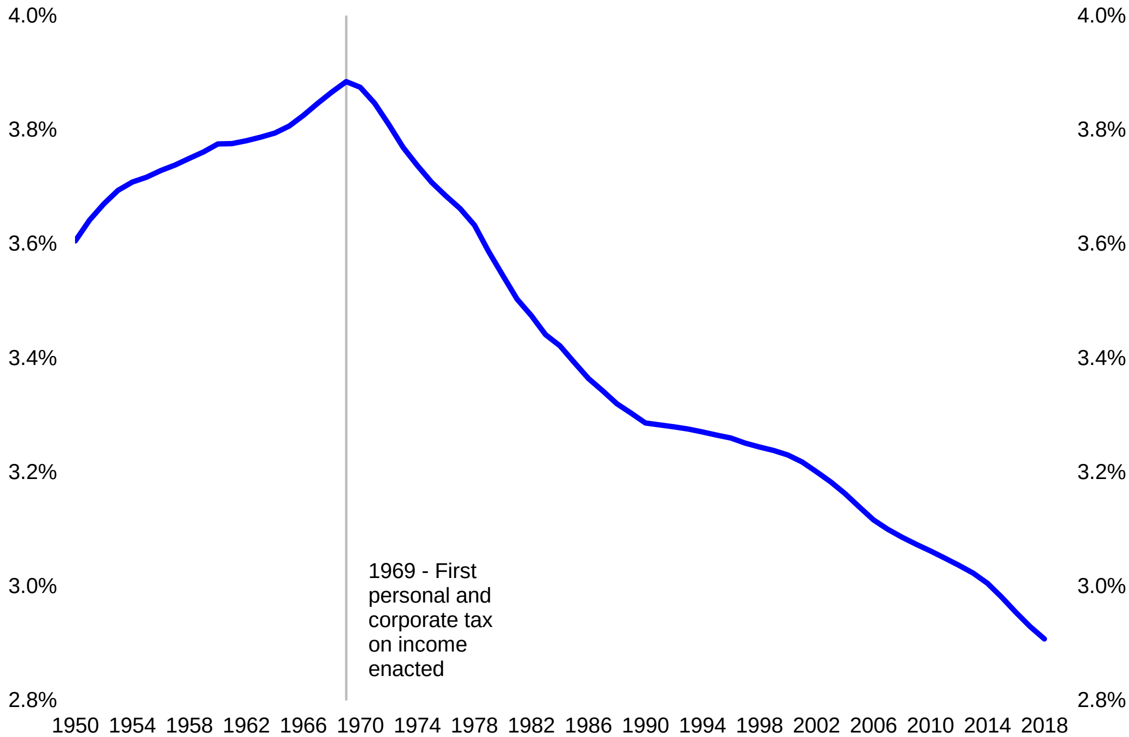
Chicago, once the second largest city in the U.S., is not immune to the migration impact of poor fiscal policy. Figure 8 plots the share of U.S. population living in the Chicago metropolitan area. Prior to the adoption of an Illinois state income tax, Chicago was actually expanding relative to the rest of the U.S. Chicago's decline began exactly when the state adopted its income tax in 1969. In 2017, Chicago lost a net of 156 people per day.[16]

[16] "Sweet home Chicago sours as 156 residents leave daily," Crain's Chicago Business, December 14, 2018. https://www.chicagobusiness.com/news/sweet-home-chicago-sours-156-residents-leave-daily

Figure 8

Chicago Metropolitan Statistical Area Population[17] as a Share of U.S. Population

(annual, 1950-2018)



Source: Bureau of Economic Analysis, U.S. Census Bureau

Illinois shares a land border with five states—Indiana, Iowa, Kentucky, Missouri and Wisconsin. Over the past decade, all these states have implemented tax rate reductions.

Indiana has been steadily decreasing its corporate income tax rate since 2012. Once as high as 8.5%, Indiana's corporate rate is on track to be reduced to 4.9% by July 1, 2021 (fiscal year 2022).[18] Indiana's personal income tax rate has been reduced from 3.4% to 3.23% in the past decade, as well.[19]

In 2018, Iowa Governor Kim Reynolds signed several large income tax reductions into law. Iowa's highest marginal personal income tax rate of 8.98% will be reduced to a 6.5% rate by 2023; in combination with Illinois' potential tax rate increases, Iowa could tax income at a lower rate than Illinois in just a few years' time. Iowa's corporate income tax rate will also be decreased from 12% to 9.8% on January 1, 2021.[20] Governor Reynolds was aiming for further tax reductions

[17] Data points for 1951-1959 and 1961-1968 were interpolated based on decennial Census data.
[18] https://www.in.gov/dor/business-tax/tax-rates-fees-and-penalties/corporate-tax-and-sales-tax-history/
[19] https://taxfoundation.org/indiana-approves-income-tax-reduction/
[20] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-iowa-enacts-income-tax-and-sales-use-tax-changes.pdf

through her proposed Invest in Iowa Act, but these plans were derailed by the COVID-19 pandemic.[21] There is still hope that these further tax reductions will be reintroduced at a later date.

In 2018, Kentucky initiated income tax reforms that changed both personal and corporate income taxes. Both taxes were changed from progressive taxes with a top rate of 6% to flat taxes assessed at a 5% rate.[22] Missouri has set into effect a series of personal and corporate income tax reductions. Missouri's top marginal personal income tax rate has been reduced from 5.9% to 5.4%, with a further reduction to a 5.1% rate on the way.[23] The corporate income tax rate has also been reduced from 6.5% to 4%.[24] Wisconsin has also lowered income tax rates in recent years. Since 2012, the top marginal tax rate has been reduced from 7.75% to 7.65%, and the lowest marginal tax rate has been reduced from 4.6% to 4%.[25]

All five states that border Illinois are improving their tax code. Illinois has been losing residents to these states for many years, and this trend will only be exacerbated by the anti-growth policies adopted by Illinois and the pro-growth policies adopted by Illinois' neighbors.

It is not just people leaving the state – companies are also moving their headquarters to escape the toxic business environment of Illinois.[26] The tax rate increases that could result from Constitutional Amendment 1 won't help the cause. This constitutional amendment is in addition to other anti-growth policies recently adopted by Illinois. In 2019, Illinois doubled the state gasoline tax from 19 to 38 cents per gallon, which has imposed a significant burden on Illinois drivers and business owners.[27] A plan to raise the minimum wage to $15 an hour by 2025, also signed by the governor in 2019, will further weaken the viability of small businesses.[28] All this out-migration of people and businesses has a compounding effect on economic conditions. You need jobs to attract people and you need people to attract jobs.

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[21] https://www.desmoinesregister.com/story/opinion/columnists/iowa-view/2020/02/13/iowa-pro-growth-tax-reform-2020-invest-iowa-act-reynolds/4752012002/

[22] https://taxfoundation.org/kentucky-tax-reform-package/

[23] https://dor.mo.gov/personal/whatsnew/#:~:text=Missouri%20Standard%20Deduction&text=Below%20are%20the%20standard%20deduction,Married%20Filing%20Separate%20%2D%20%2412%2C200

[24] https://dor.mo.gov/business/corporate/whatsnew/

[25] https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2019/0002_individual_income_tax_informational_paper_2.pdf

[26] Anna Marie Kukec, "Illinois Loses Out as Companies Move Out," U.S. News, March 23, 2018. https://www.usnews.com/news/best-states/articles/2018-03-15/companies-want-out-of-illinois

[27] Brittany De Lea, "Illinois tax hikes could kill small businesses, expert warns," Fox Business, July 1, 2019.

[28] "Pritzker Signs Law Raising Illinois Minimum Wage To $15 An Hour By 2025," CBS Chicago, February 19, 2019. https://chicago.cbslocal.com/2019/02/19/jb-pritzker-illinois-minimum-wage-15-dollars-an-hour/

Illinois Has a Spending Problem, Not a Revenue Shortage

We have outlined countless deleterious effects that come with tax hikes. Then why on Earth would Illinois worsen its tax code? The answer lies in Illinois' dire need for new tax revenues.

On June 6th, 2019, Governor Pritzker signed a 2020 fiscal year state budget that shows state coffers with as much as a $1.3 billion deficit, even after accounting for almost $1.1 billion in projected new revenues from various tax and fee increases.[29] Unfortunately for Governor Pritzker, the new tax changes will not result in such a windfall of new tax revenues. Migration out of Illinois, lost jobs, and lost businesses will restrict the tax base and will limit new tax revenues well below the static estimate of $1.1 billion.

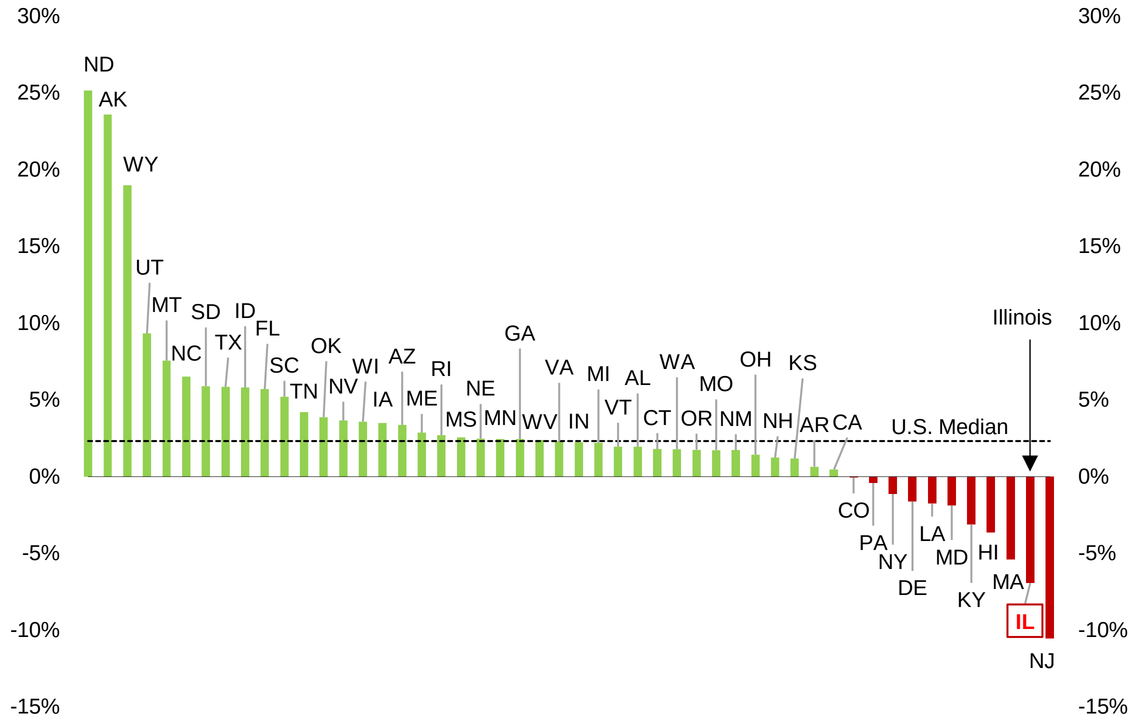
Budget woes have long troubled Illinois because politicians like spending more than producing sustainable growth. FY 2020 is the 19th consecutive year Illinois has had a budget deficit. Figure 9 shows each state's budget surplus as a share of state spending over the latest ten-year period for which data are available. Illinois is second from the bottom, only "bested" by New Jersey.

[29] Adam Schuster, "Pritzker Signs Illinois Budget out of Balance by up to $1.3 Billion," Illinois Policy Institute, June 11, 2019. https://www.illinoispolicy.org/pritzker-signs-illinois-budget-out-of-balance-by-up-to-1-3-billion/

Figure 9

Budget Surplus/Deficit as a Share of Total Government Spending

(average since FY 2008)



Source: Pew Charitable Trusts

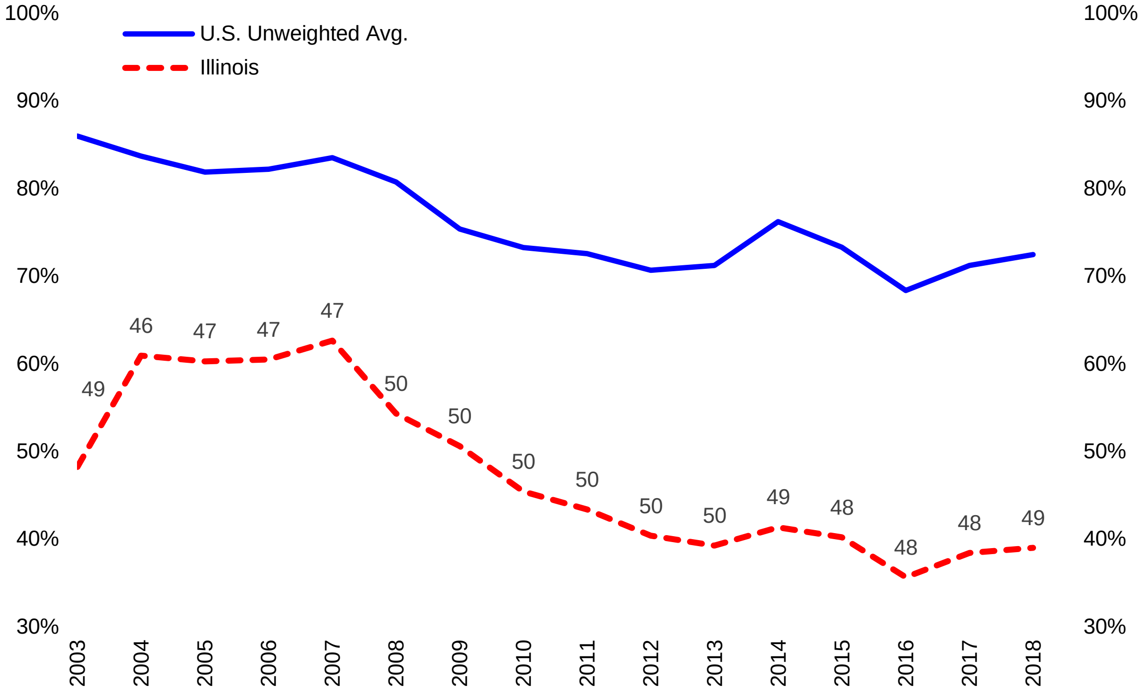
Many of the problems currently plaguing The Prairie State stem from the state's misaligned incentive structure. Businesses and workers want to be located where they get the most benefit for their efforts after tax. Work is more rewarding when government taxes you less. Over the years, Illinois has become known as a high-tax state whose government tends to spend way too much money. The only way Illinois could become worse is by raising taxes even higher, as it intends to do.

Budget, revenue and economic growth issues always spell trouble for public pensions. Illinois is no exception. Figure 10 plots the funding ratio for Illinois and the U.S. Illinois' state rankings are shown above the line. Illinois' best performance was 46th out of 50 in 2004, and its highest funding ratio was at an abysmal 62.6 percent in 2007. The funding ratio has been falling almost every year since 2007 and fell to a low of 35.6% in 2016. Unfortunately, the victims of these bad policies are not the politicians who caused them.

Figure 10

State Pension Funding Ratio, Illinois vs. the U.S.

(annual, 2003-2018)



Source: Pew Research

For a more in-depth look, Table 5 shows the state's pension fund liabilities, assets, net indebtedness, funding ratio and funding ratio's rank in the U.S. The state is making promises it cannot keep. Note the growth in liabilities from 2008-2013 and then compare those numbers with the growth (or lack thereof) in pension assets. Liabilities grew 39% while assets only managed 0.4% growth over the five-year period. Net pension debt has more than tripled since 2007. An Illinois Supreme Court decision that ruled it was unconstitutional to alter the pension benefit formula has not done them any favors.[30]

[30] Megan Davies and Karen Pierog, "Illinois' supreme court overturns state's 2013 pension reform law," Reuters, May 8, 2015. https://www.reuters.com/article/us-illinois-pensions/illinois-supreme-court-overturns-states-2013-pension-reform-law-idUSKBN0NT1U220150508

Table 5

Summary of Illinois State Public Pension Funding

(annual, FY 2003-2018, billions of current dollars)

FY	Liability	Assets	Net Pension Debt	Funded Ratio	Funding Rank
2003	$83.83	$40.42	$43.40	48.2%	49
2004	$89.83	$54.74	$35.09	60.9%	46
2005	$97.18	$58.58	$38.60	60.3%	47
2006	$103.07	$62.34	$40.73	60.5%	47
2007	$112.91	$70.73	$42.18	62.6%	47
2008	$119.08	$64.70	$54.38	54.3%	50
2009	$126.44	$64.00	$62.44	50.6%	50
2010	$138.79	$63.05	$75.74	45.4%	50
2011	$146.46	$63.55	$82.91	43.4%	50
2012	$158.61	$64.03	$94.58	40.4%	50
2013	$165.46	$64.96	$100.50	39.3%	50
2014	$190.18	$78.63	$111.55	41.3%	49
2015	$199.09	$80.02	$119.07	40.2%	48
2016	$219.35	$78.18	$141.17	35.6%	48
2017	$222.27	$85.39	$136.88	38.4%	48
2018	$230.42	$89.82	$140.59	39.0%	49

Source: Pew Research

Boasting the worst credit rating of any state in the nation (BBB- from S&P, just one level above junk status), Illinois is struggling to service its debts. As of 2017, Illinois' debt service to tax revenue ratio was 10.1%, coming in as the second worst in the nation. Illinois' credit rating was downgraded 21 times across the three major NRSROs (Fitch, Moody's and S&P) from 2009 through 2017. Table 6 displays the current S&P State General Obligation Bond Ratings as of September 1, 2020. Illinois is caught in a death spiral.

Table 6

Current S&P State Credit Ratings

(as of September 1, 2020)

State	Credit Rating	Rank	State	Credit Rating	Rank	State	Credit Rating	Rank
DE	AAA	1	NV	AA+	16	NH	AA	26
FL	AAA	1	NY	AA+	16	NM	AA	26
GA	AAA	1	ND	AA+	16	OK	AA	26
IN	AAA	1	OH	AA+	16	RI	AA	26
IA	AAA	1	OR	AA+	16	WI	AA	26
MD	AAA	1	SC	AA+	16	WY	AA	26
MN	AAA	1	VT	AA+	16	AK	AA-	41
MO	AAA	1	WA	AA+	16	CA	AA-	41
NE	AAA	1	AL	AA	26	KS	AA-	41
NC	AAA	1	AZ	AA	26	LA	AA-	41
SD	AAA	1	AR	AA	26	WV	AA-	41
TN	AAA	1	CO	AA	26	PA	A+	46
TX	AAA	1	ME	AA	26	CT	A	47
UT	AAA	1	MA	AA	26	KY	A	47
VA	AAA	1	MI	AA	26	NJ	A-	49
HI	AA+	16	MS	AA	26			
ID	AA+	16	MT	AA	26	**IL**	**BBB-**	**50**

Source: Bloomberg, CNBC

An Econometric Analysis of the Illinois Fair Tax

As mentioned above, the pending amendment and preemptively passed legislation would create a top marginal personal income tax rate of 7.85%, and an absolute income tax rate of 7.99% on incomes over $750,000 through a recapture mechanism. That recapture mechanism of the law would create a significant tax cliff and considerable disincentives. The last dollar of a person's income could cost nearly $9,000 in taxes. The amendment would also result in a 10.49% combined corporate tax rate. Only New Jersey would have a higher corporate tax rate. Only five states would have higher rates on pass-through income, and only seven states would have higher rates on nonbusiness income.

Although it is certainly possible that there will be additional tax increase over the next decade, the following econometric analysis assumes no additional tax increases during that time. One such example of an additional tax increase would be the decision to tax retirement income, a scenario that would be possible should the amendment in question pass. In fact, every state with a progressive income tax system taxes retirement income, making this likely in Illinois after the amendment's passage.[31] That fact notwithstanding, we only account for those factors which are currently known in order to speculate as little as possible.

[31] The flood of retirees out of a state is very damaging to the state's economy. Not only do those individuals take their economic activity with them, but they also take their tax revenue with them as well. Consequently, those retirees on public pensions who leave the state in which they had worked are still receiving payments from their former state but no longer providing it with sales, property, income, or excise tax revenue.

The proposed progressive tax system that would be implemented if the amendment passes amounts to a 3.04 percentage point increase from the current personal income tax rate, and a 0.99 percentage point increase from the current corporate income tax rate. These rate increases will accelerate tremendously the negative domestic migration that Illinois has been experiencing.

As of mid-2019, Illinois' population estimate from the Census Bureau was 12,671,821.[32] The progressive tax system being proposed would, on average, cause 148,000 additional people to leave the state every year, on average, over the next decade. That is above and beyond the existing outmigration trend that Illinois has been experiencing. Illinois lost 1.2% of its population over the last decade. The progressive tax amendment would, on average, cause Illinois to lose nearly that same percentage annually in additional outmigration. This analysis, however, makes no claims as to other factors of population growth and decline, such as birth and death rates. As such, this is an estimate of outmigration, not total population decline which may be smaller or larger. Also, after the first decade, the amount of additional outmigration due to the progressive tax decreases dramatically, in part because over a million of those most affected by the tax increase will already have left the state.

The higher tax rates are also predicted to slow economic growth in the state. The outmigration and slower economic growth combined will result in approximately 566,000 fewer jobs created over the next decade – a loss of about one in ten jobs currently in the state. Given the relatively anemic pace of job creation in Illinois[33] compared to the national average, it is possible that this could push the state's employment numbers down to no net job growth in non-farm payrolls over the coming decade.

The progressive income tax would also significantly slow the growth of home values, largely due to the flood of people fleeing the state. This is particularly devastating to all those residents whose homes are not merely dwellings, but also investments that will one day be sold to help fund their retirement. Growth in home values will be approximately 10.4% lower at the end of the decade than if the progressive tax were not enacted.

Lastly, just as California's 2012 tax increase did not achieve its revenue projections, neither will Illinois' progressive tax scheme. California's top marginal rate increase of 3 percentage points caused an additional 0.8% of high-income households to flee the state, going primarily to states with no income tax. Between the outmigration and the behavioral

[32] https://www.census.gov/quickfacts/IL
[33] U.S. Bureau of Labor Statistics, All Employees: Total Nonfarm in Illinois [ILNA], retrieved from FRED, Federal Reserve Bank of St. Louis

responses of those who remained, the supposed windfall California was to receive from the tax rate increase turned out to be 45.2% less than expected in the first year and 60.9% less than expected in the second year.[34] Considering that California “draws about half its income tax revenues from roughly 150,000 tax returns,”[35] the loss of just a few of those tax returns causes a noticeable dent in the state’s budget. Illinois’ switch to a progressive tax with a recapture mechanism would likely harvest only 39% of its projected revenue for the same two reasons that California’s tax increase failed to achieve its anticipated revenue gains. However, now that there is a cap on SALT deductions, these effects are greatly amplified, resulting in an even larger disparity between the static and dynamic projections. Additionally, Illinois’ tax increase, while nearly identical on percentage-point terms, is significantly higher as a percentage of the existing tax rate.

<u>Conclusion and Other Concerns</u>

From a tax and overall economic competitiveness standpoint, the only saving grace in Illinois is the flat personal income tax rate. The state’s corporate tax rate is already very uncompetitive, its sales, gasoline, and property taxes are among the highest in the nation, and it is one of only a dozen states that imposes estate taxes. In that regard, adding a progressive income tax, especially one with a recapture mechanism, will be the last straw for anyone considering leaving, and the final nail in the coffin of the state’s finances.

Additionally, the proposed progressive tax system does not index the tax rate brackets for inflation, subjecting low- and mid-income earners to bracket creep. This is particularly concerning amid record-setting borrowing at the federal level as sovereign debt explodes, increasing inflationary fears. There is also a heavy marriage penalty and the business tax rates do not achieve their supposed goals of “parity” with personal income tax rates, especially since C-Corps are effectively doubled taxed. Corporate and pass-through income are likewise unequal.

The current “Fair Tax” proposal would have at least four severely damaging effects. First, it will speed up by almost tenfold the outmigration from Illinois with approximately 1.48 million people migrating to other states over the next decade. Second, it will lower job growth by about 566,000 jobs over that same time. Thirdly, appreciation of home prices will be hamstrung, ending the decade 10.4% lower than they would otherwise be. And fourth, the tax system will likely raise less than 40% of the revenue its proponents claim will pour into the state’s coffers.

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[34] Rauh Joshua, Ryan J. Shyu. “Behavioral Responses to State Income Taxation of High Earners: Evidence from California” The National Bureau of Economic Research NBER Working Paper No. 26349 July 2020.
[35] Victor Davis Hanson The Case for Trump, New York, NY: Basic Books, 2019.

Illinois has a clear need for new revenues. But raising tax rates on businesses and individuals is not the correct way to find these revenues. Raising taxes may lead to increased revenues in the short term, but over the long run, Illinois' economy will be severely hindered by these tax changes and these new tax revenues will dry up.

Appendix

Coefficients for the effects of top marginal, or top absolute, tax rates are taken from Table 7, derived from regression analysis on a ten-year balanced panel dataset for state tax rates.

Table 7

Estimation Results (2) [WLS]

Intercept	0.0796***
	(0.0165)
(δ_1)Pers Inc$_{it}$	-0.2013***
	(0.0508)
(δ_2)Pers Inc$_{it}$	-0.3510***
	(0.0928)
Corp Inc$_{it}$	-0.1049**
	(0.0440)
(δ_1)Property$_{it}$	-2.0848***
	(0.2759)
(δ_2)Property$_{it}$	-2.6025***
	(2.1556)
(δ_1)Sales$_{it}$	-0.0033***
	(0.0006)
(δ_2)Sales$_{it}$	-0.0031***
	(0.0009)
Gas$_{it}$	-0.0002
	(0.0001)
U6$_{it}$	-0.1220***
	(0.0348)
RPP$_{it}$	0.0000
	(0.0002)

***denotes significance at the .1% level

The domestic migration effect of the personal income tax rate increase is -1.067040% while the effect of the corporate income tax rate increase in -0.103851%, for a combined effect of -1.170891%. Given a population of 12,671,821 in Illinois, this yields an annual outmigration effect (rounded down to the nearest thousand) of 148,000.

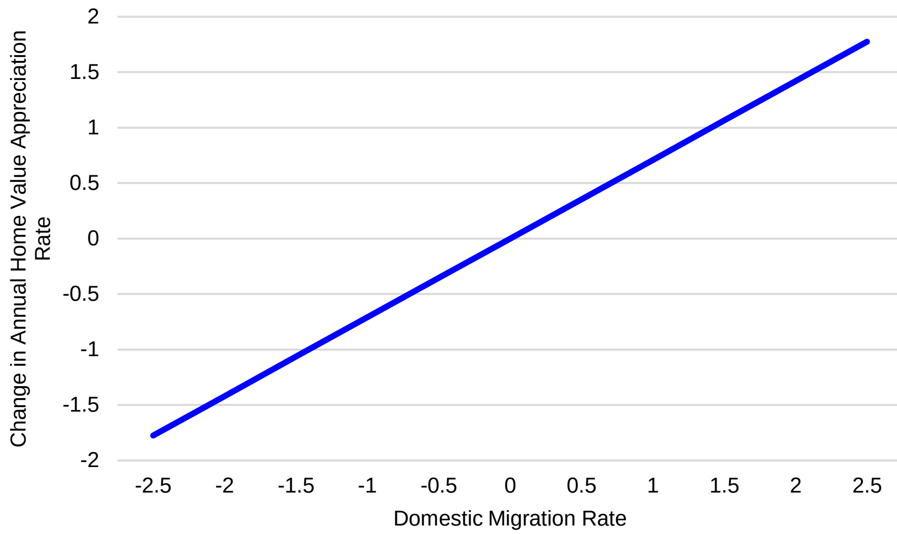
Domestic migration losses are crucial to predicting job losses since the decrease in population decreases both labor demand and labor supply. (Since many jobseekers will be part of the outmigration trend, this analysis does not predict a significant increase in unemployment, although other analyses have demonstrated states with high and progressive tax structures tend to experience relatively high unemployment.) Higher tax rates on personal income, pass-through income, and corporate income all create either disincentives to work or disincentives to hire, further decreasing labor supply and labor demand, respectively. It is assumed that the current nationwide recession will be short lived, with the economy returning to its long-term growth trend and the trough of the "V" representing permanently lost economic activity. Therefore, employment figures from the end of 2019 were used as a baseline in performing estimations. The arithmetic follows:

$$6{,}121{,}800(0.0304 * \text{-}0.11 + 0.0099 * \text{-}0.22) + 1{,}480{,}000 * \text{-}0.36 = \text{-}566{,}605$$

While -567,000 is the nearest thousand, -566,000 is a slightly more conservative estimate and this analysis would rather err on the side of caution, no matter how small the difference.

The aforementioned exodus that the progressive tax would cause in domestic migration would decrease housing demand, putting downward pressure on home values and, therefore, slow home value appreciation. Assuming a 2.9% average annual home value appreciation, at the end of the decade, a home would be worth 33.1% more. Figure 11 shows the relationship between domestic migration and home value appreciation, estimated using data from the last decade.

Figure 11
Effect of Domestic Migration Rates on Average Annual Home Value Appreciation Rates



The decline in a state's domestic migration rate correlates with a 0.83% reduction in average annual home value appreciation, yielding an average annual growth rate of 2.07% and a growth rate of 22.7% over the decade, which is 10.4% less by the decade's end relative to no progressive tax. Given a conservative estimate of the median Illinois home value of approximately $200,000 under this scenario, the progressive tax represents $20,800 in lost home value after 10 years. Please note that the 10.4% difference is dependent upon an assumed 2.9% average annual growth rate. A faster rate in the next ten years, which is certainly possible given heightened inflationary concerns, would exacerbate the difference, while a housing slowdown with anemic increases in home values would reduce the disparity. Conversely, if home values were depreciating, perhaps during a recession, any further slowdown in housing appreciation (increasing negative magnitude) would also exacerbate the difference in the two outcomes of the progressive tax versus no progressive tax.

Finally, the tax increase is supposedly targeted at the top 3% of income earners since its proponents claim that the bottom 97% of income earners will receive a tax cut. (Since more than 7% of Illinois' households are millionaire households, this seems dubious, especially since millionaire households do not tend to have substantially fewer household members than non-millionaire households, although millionaire households do tend to have more income earners than average.) Regardless of whether or not only 3% of Illinoisans will have a higher income tax bill, it is clear that the rate increases are directed at those taxpayers who tend to be both the most mobile and those who are best equipped to engage in behavioral changes to legally reduce their tax burdens. Of the $3.6 billion expected to be raised annually, 36% of this additional revenue will likely be lost due to outmigration, while another 15% will be lost due to behavioral changes of taxpayers. The recapture provision is particularly harmful here and highly distortionary to static estimates because of the extreme tax cliff that it creates. A married person earning $1 million pays $70,935 in state income tax but earning one dollar more increases the taxes owed to $79,900, an $8,965 increase. This creates a $9,744 range of income wherein the taxpayer has a higher, or equal, after-tax income by earner fewer pre-tax dollars. The $3.6

billion static annual estimate is likely a gross overestimate of actual likely revenue. Instead, a dynamic estimate of 39% would be $1.404 billion a year, on average. It is important to note that revised static estimates made after the first five years of the progressive tax would likely be much more accurate since most of the difference between the initial static and dynamic estimates is due primarily to a large initial exodus, similar to the results in California and Connecticut in recent years. The perverse incentives of the recapture mechanism in the tax code would still remain, but since people would have adjusted their earned incomes to accommodate this mechanism, the number of tax returns in this prohibitive range would be substantially lower, again pointing to greatly increased accuracy in a revised static estimate.