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Issue Brief

Tax Relief from the Phase-down of the Personal Income Tax Disproportionately Goes to Illinois' Wealthiest

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1. SUMMARY OF IMPACT

Many know that on January 1, 2015, the temporary increases made to the state's income tax rates that became law under the Taxpayer Accountability and Budget Stabilization Act of 2011 (**TABSA**) began to phase-down. On that date, the personal income tax rate declined from 5 percent to 3.75 percent, while the corporate rate went from 7 percent to 5.25 percent. What is not well known is:

- who benefited most from the cut to the personal income tax rate under TABSA, and
- whether or not that tax cut can reasonably be expected to stimulate the Illinois economy.

As it turns out, more than half (54.4 percent) of the dollar value of the tax relief from the reduction in the state's personal income tax—over $2 billion of the $3.7 billion in total cuts—goes to the wealthiest 11.8 percent of tax filers in Illinois. Indeed:

- Millionaires do particularly well, as they will receive an average annual tax break of $36,797 per year. To put that in context, the average annual tax break for millionaires under TABSA will be anywhere from 70 to 344 times more than the average, annual tax break the phase-down generates for the bottom 70 percent of Illinois families, who have net taxable incomes of $50,000 per year or less.
- The bottom 50 percent of income earners in Illinois will fare particularly poorly, receiving just 8.1 percent of the total tax break generated by the phase-down of the state's personal income tax rate.
- So much of the tax relief provided under TABSA goes to upper income families in Illinois, that it will actually worsen income inequality in the state.

Finally, by focusing the majority of tax relief on top income earners, the phase-down of the personal income tax rate cannot be expected to generate much economic activity. That's because the economy is primarily made up of consumer spending, and typically, affluent families are not likely to spend most of the tax relief they receive, because their disposable income is already increasing significantly over time. Given this growth in disposable income, affluent families do not have significant unmet needs, and tend to save rather than spend what they receive in tax relief.

Low and middle income families, however, have greater unmet needs because in real terms their earnings are declining over time.[1] So when low or middle income households obtain an additional dollar of income—say through targeted tax relief—they tend to spend that dollar in the consumer economy. Unfortunately, the bottom 60 percent of income earners in Illinois will receive only $491 million or 13.2 percent of the $3.7 billion in tax relief from the phase-down, which greatly diminishes any potential the phase-down has to stimulate spending.

In fact, to the extent that there is any mild stimulative impact that can be anticipated from the phase-down of the personal income tax rate, it will be negated by the public service spending cuts that will have to be made to pay for the $3.7 billion loss in recurring tax revenue it causes.

2. WHO BENEFITS THE MOST FROM THE PERSONAL INCOME TAX RATE PHASE-DOWN?

To obtain an accurate estimate of how the tax cuts implemented by the phase-down of the state's personal income tax rate from 5 percent to 3.75 percent will actually benefit Illinois taxpayers, a number of simple computations had to be made. First, to isolate the impact this tax cut will have on in-state families, only the income tax data for Illinois residents was considered. This required excluding data concerning taxpayers who either were partial year residents or were not residents of the state, but nonetheless were subject to the state's income tax.

Next, the benefit of the tax cut had to be analyzed across income classifications based on Illinois "Net" (i.e. "taxable") income, rather than gross earnings or federal Adjusted Gross Income amounts. That is because taxable income in Illinois is different in some key ways than taxable income at the federal level (e.g., no retirement income is subject to the Illinois income tax, whereas most retirement income is subject to the federal income tax). Moreover, the Illinois Department of Revenue (**IDOR**) maintains its database using Illinois "Net" (that is "taxable") income. What this means is that, because of the various deductions an individual is entitled to claim on his or her Illinois income tax return, an Illinois taxpayer's actual annual earnings are generally greater than his or her "Net" Illinois income. Hence, Figure 1 shows how the total dollar value of the tax cut created by the recent phase-down of the state's personal income tax rate will be distributed to Illinois taxpayers based on their Net incomes.

Figure 1
Share of Tax Cut by Net Illinois Income—Illinois Residents Only
(Estimate Done Using 2011 Income Tax Data)

Net Illinois Income Group	Total Difference between 3.75% and 5% for Income Bracket	% of Tax Benefit	Average Cut	Average Net Illinois Income	Average Adjusted Gross Income	% of Tax Filers
$0-$25,000	($301,052,960)	8.1%	($106.89)	$8,550.90	$18,964.43	50.4%
$25,001-$35,000	($189,646,232)	5.1%	($372.32)	$29,785.39	$39,082.14	9.1%
$35,001-$50,000	($300,654,609)	8.1%	($526.45)	$42,115.75	$51,775.10	10.2%
$50,001-$75,000	($492,169,307)	13.2%	($768.78)	$61,502.31	$71,740.42	11.5%
$75,001-$100,000	($418,908,679)	11.2%	($1,080.17)	$86,413.26	$97,258.15	6.9%
$100,001-$200,000	($809,279,182)	21.7%	($1,677.04)	$134,162.76	$146,324.98	8.6%
$200,001-$1,000,000	($717,656,313)	19.2%	($4,371.34)	$349,706.85	$365,598.00	2.9%
$1,000,001 or Greater	($503,206,395)	13.5%	($36,797.54)	$2,943,802.83	$2,976,255.53	0.2%
Total	($3,732,573,676)	100.0%	($668.28)	$53,462.03	$64,072.49	100.0%

Source: CTBA analysis of the Illinois Department of Revenue's Personal Income Tax data for tax year 2011. Numbers do not add up due to rounding.

As shown in Figure 1, it is estimated that the wealthiest households in the state, those with net taxable incomes in excess of $1,000,000 (with an average annual AGI of nearly $3 million)—who make up just 0.2 percent of all Illinois taxpayers—will receive 13.5 percent of the total tax cut resulting from the phase-down in the personal income tax rate. In fact, over $1.2 billion, or roughly one-third of the total tax relief, goes to just the wealthiest 3.1 percent of taxpayers***. Indeed, the average, annual tax break of nearly $37,000 that millionaires receive from the phase-down of the state's personal income tax rates is roughly 70 times greater than the***

average, annual tax break of $526 for families with taxable incomes that range from $35,000-$50,000 per year.

Unfortunately, IDOR's data could not be sorted by the standard "top 10 percent in earnings versus the bottom 90 percent" typically utilized in these types of comparisons. The closest to that metric into which the IDOR data could be sorted was the top 11.8 percent compared to the bottom 88.2 percent. However, that comparison, which is shown in Figure 2, is eye-opening.

Figure 2
Comparison of Tax Cut by Net Illinois
(Estimate Done Using 2011 Income Tax Data)

Net Illinois Income Bracket	Difference between 3.75% and 5% tax rate for Income Bracket	% of Tax Benefit	% of Tax Filers
$0-$100,000	($1,702,431,787)	45.6%	88.2%
$100,001 and Greater	($2,030,141,890)	54.4%	11.8%

Source: CTBA analysis of the Illinois Department of Revenue's Personal Income Tax data for tax year 2011.

As illustrated in Figure 2, the majority of the tax relief from the phase-down of the income tax—over 54 percent—is estimated to go to the wealthiest 11.8 percent of taxpayers. This leaves only 45.6 percent of the benefit of the tax cut for the bottom 88.2 percent of Illinois taxpayers with "Net" incomes of $100,000 or less. Moreover, even within that latter group, tax relief is unequally distributed. ***Households with taxable net incomes of less than $25,000, which make up over half of all income tax filers in the state, will receive just 8.1 percent of the total tax relief from the January 1, 2015 phase-down.***

3. TARGETING TAX RELIEF TO THE WEALTHIEST FAMILIES IS NOT LIKELY TO STIMULATE THE ILLINOIS ECONOMY

One of the primary reasons used to justify tax relief is creating an economic stimulus. Certainly, the state of Illinois could use such a stimulus, given that its economic growth has lagged both the U.S. and Midwest since the Great Recession ended.[2] Unfortunately, the tax relief provided by the phase-down of the state's income tax rates under TABSA cannot reasonably be expected to have a stimulative impact on the Illinois economy. The reasons for this are fairly simple to understand.

For an income tax break to serve as an effective economic stimulus, two conditions must be satisfied. First, the tax break itself must be targeted to enhance consumer spending. This typically stimulates growth, because consumer spending makes up such a significant portion of the economy overall, accounting for 68-70 percent of all economic activity at both the state and national levels.[3] Second, the value of the enhanced consumer spending generated by the tax break cannot be paid for by cutting spending on core services. Indeed, the body of research indicates that when governments offset the dollar value of tax breaks with cuts to service expenditures, the net impact on the economy is negative.[4]

To satisfy the first condition and effectively stimulate consumer spending, income tax relief has to be focused on low to middle income families, because they have a much greater "Marginal Propensity to Consume" (**MPC**) than do higher income families.

A family's "Marginal Propensity to Consume" is simply the economic term for how much that family's consumer spending habits will change, relative to changes in family income. Families with fewer available resources have a higher MPC than those with more resources, for obvious reasons.[5] Generally, those with less resources have material unmet needs, so when they obtain an additional dollar of income, they tend to spend a greater portion of that additional dollar than would a high-income household.

Why low to middle income families have such a high Marginal Propensity to Consume is easy to understand once the growth in income inequality over time is considered. The period between the end of World War II and the late 1970s was a positive time economically for most American families, regardless of income level. During that sequence, all segments of the population realized income growth after inflation, leaving the gaps between higher income and lower income households mostly unchanged.[6] Since 1979, however, the incomes of the highest earning households have grown at a much faster rate than those of others. Indeed, after factoring in inflation, the bottom 90 percent of households in the U.S. have seen their incomes decline since 1979, while the top ten percent have seen their incomes increase, as highlighted in Figure 3.

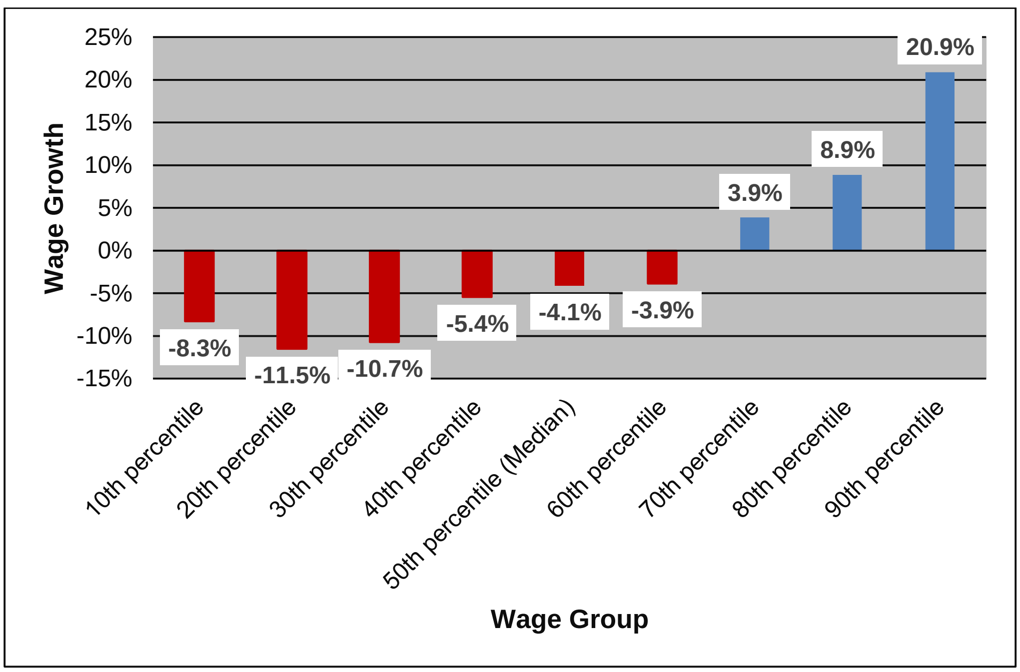
Figure 3
Change in Average US Income Growth over Time

Income Group	1947— 1979	1979 — 2011
Top 10%	34.1%	139.8%
Bottom 90%	65.9%	-39.8%

Source: Economic Policy Institute. Data used is from Piketty and Saez, "Income Inequality in the United States, 1913-1998", *Quarterly Journal of Economics*, 118(1), 2003, 1-39 (Tables and Figures Updated to 2011 in Excel format, January 2013), http://elsa.berkeley.edu/~saez/

Moreover, growth in income inequality is not just a national phenomenon. It has also held true for households in Illinois. As shown in Figure 4, when adjusted for inflation, the lowest earning 60 percent of Illinois households saw a real decline in wages during the period between 1979 and 2014. In contrast, the highest earning 40 percent of households saw real-wage growth over the same period, with the top 10 percent realizing over 20 percent growth in wages over this sequence.

Figure 4
Change in Inflation Adjusted Real Wages in Illinois, 1979-2014



Source: Economic Policy Institute analysis of Current Population Survey data, adjusted for inflation using the CPI-U-RS.

As indicated previously, the vast majority of the tax relief from the phase-down of the state's income tax rates is projected to benefit high-income households in Illinois that have a low MPC. Indeed, fully 78.8 percent or $2.94 billion of the total $3.73 billion tax cut provided by the personal income tax rate reduction under TABSA goes to the top 30 percent of taxpayers in Illinois, who have low MPCs and have had growth in real income over time. **Hence, little or no stimulative impact can reasonably be projected to be generated by the vast majority of the tax relief provided by the phase-down in the personal income tax rate.**

Meanwhile, the bottom 60 percent of income earners in Illinois—who have experienced real loss in wages over the last 30 years—receive just 13.2 percent, or $491 million of the $3.7 billion in total tax breaks provided by the phase-down.

It is particularly hard to support the phase-down of the personal income tax rate under TABSA, when that phase-down is considered in context of the growth in income inequality occurring nationally and in Illinois. Providing a tax cut to millionaires—who constitute just the wealthiest 0.2 percent of all Illinois families—that has a dollar value some 70 times or more greater than the tax cut given to the bottom 60 percent of the state's income earners, will actually worsen income inequality in Illinois, while providing no material stimulus to the economy. Finally, even if the bottom 60 percent of income earners in Illinois used their entire $491 million in tax relief to increase their consumer spending, the slight bump in economic activity that this would generate will be more than offset by the potentially multi-billion dollar spending cuts Illinois would have to implement to pay for the total tax break cost of $3.7 billion.[7]

4. LIKELY IMPLEMENTATION OF SPENDING CUTS TO PAY FOR THE TAX CUTS CREATED BY PHASE-DOWN OF THE STATE'S INCOME TAX RATES

While on the one hand the tax relief provided by the phase-down of the state's individual income tax rate cannot be expected to generate a meaningful economic stimulus, on the other it will have a very significant impact on the state's budget. The phase-down of the personal and corporate income tax rates that became effective on January 1, 2015, took place halfway through the state's current fiscal year—FY 2015 (which began on July 1, 2014 and runs through June 30, 2015). While the rate reduction created a significant revenue loss in FY2015 compared to FY2014, its impact will be somewhat mitigated, since the reduced income tax rates will be in effect for only six months of FY2015. Things will be worse in FY2016, because those reduced income tax rates will be in effect for the full fiscal year. As a result, it is estimated that General Fund revenue in FY2016 will be some $5 billion less than it was in FY2014, as shown in Figure 5.

Figure 5
General Fund Recurring Revenue Comparison
FY2014 Actual to FY2016 Projected ($ Millions)

	FY2014 (Actual)	FY2016 (Projected)
General Fund Revenue	$36,718	$31,710
Difference ($)	N/A	($5,008)
Difference (%)	N/A	-13.6%

Sources: FY2014 from COGFA, *State of Illinois Budget Summary Fiscal Year 2015* (Springfield, IL: August 2014), 25; and FY2016 from COGFA, *3-Year Budget Forecast FY2015-FY2017* (Springfield, IL: March 2014), 12.

Governor Bruce Rauner has indicated that spending will be cut to accommodate the aforementioned $5 billion revenue loss. By one estimate, state agencies are even being asked to cut their current, FY2015 budgets by 20 percent.[8] If such a policy is fully implemented across the board, service spending could be cut by some $4.9 billion (i.e. 20 percent of the $24.9 billion appropriated for services in FY2015).[9] Given that $9 out of $10 spent through the state's General Fund go to education, healthcare, human services, and public safety, cuts of that magnitude will harm virtually every community in Illinois, and provide no corresponding benefit. Indeed, the imposition of the significant General Fund spending cuts needed to pay for the tax cuts under TABSA will more than offset any stimulative economic impact the tax cuts may generate.

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APPENDIX A: ENDNOTES

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[3] Chandra, Shobhana, "Growth in U.S. Slows as Consumers Restrain Spending," Bloomberg Business (July 27, 2012), http://www.bloomberg.com/news/articles/2012-07-27/economy-in-u-s-grows-at-1-5-rate-as-consumer-spending-cooled.

[4] Judith Stallman, David Valentine, and Andrew Wesemann, *Policy Brief: Public Expenditures and Economic Growth* (Columbia, MO: University of Missouri, Institute of Public Policy, Harry S. Truman School of Public Affairs, August 2013), 4.

[5] Jappelli, Tullio and Luigi Pistaferri, *Fiscal Policy and MPC Heterogeneity*, http://web.stanford.edu/~pista/MPC.pdf.

[6] Chad Stone et al, *A Guide to Statistics on Historical Trends in Income Inequality* (2014), http://www.cbpp.org/cms/?fa=view&id=3629.

[7] Judith Stallman, David Valentine, and Andrew Wesemann, Policy Brief: Public Expenditures and Economic Growth (Columbia, MO: University of Missouri, Institute of Public Policy, Harry S. Truman School of Public Affairs, August 2013).

[8] CBS Chicago, "Rauner Asking State Budget Agencies to Come Up with Plans for Budget Cuts", (November 25, 2014).

[9] Center for Tax and Budget Accountability, "The Pending FY2016 Fiscal Cliff" (December 22, 2014).