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PUTTING GOVERNMENT FIRST: HOW TAX HIKES IMPACT ILLINOIS

FY 04 Budget Costs State Nearly 4,000 Jobs, $110 Million in Lost Investment
Tax Swap Proposal Would Destroy 77,000 Jobs

Introduction

Changes in tax policy affect the Illinois economy. Until the advent of the Illinois-STAMP it was difficult to measure exactly how changes in the Illinois tax policy affected businesses, households and state and local government.

Armed with this formal model of the Illinois economy, the Illinois Policy Institute has the ability to dynamically score proposed changes in Illinois tax policy. In its first effort, the Illinois Policy Institute examined the FY 2004 Budget and the projected affect of one of the proposed property tax – income and sales tax swaps currently circulating amongst legislators and policy experts.

"Dynamic scoring (as opposed to static scoring) not only calculates estimated revenues from a proposed tax increase based on pure mathematical calculation, it also accounts for consumer and business behavior. For example, a business does not simply pay more taxes (implying that revenues will automatically increase). Dynamic scoring examines how a business (or individual) reacts to a tax increase. A tax increase on corporate income may increase state revenues collected from corporate income, however, other corporate spending, like capital investment, may decrease as a result of the corporation's reduction of "cash on hand."

The Institute chose to use the FY 2004 Budget in its premier STAMP study for two reasons. One, the FY04 budget, since its passage, has received a considerable amount of criticism from both state and national taxpayer groups. The second reason is that to a certain extent the FY04 Budget is still an open question. Since the passage of the FY04 budget, proposals to roll back sewer tax fees on local communities and fee increases on rolling stock have surfaced. The governor, a major proponent of the FY04 tax hikes, has all ready proposed to scrap a $1 million sales tax hike on machinery used for mining and oil exploration, reversing his own policy.

Current property tax–income tax swap legislative proposals are touted to the people of Illinois as the answer to fix Illinois' "structural deficit" and to provide more "equitable" funding for public education. While the FY 2004 Budget continues to be labeled as a house of cards built with one time revenue "gimmicks," (complete with business and fee hikes that further erode the state's business climate) property tax – income and sales tax swaps are now offered as the solution. In this study, the Institute seeks to examine that solution.

Illinois-STAMP

The economic projections offered here are based on a formal model of the Illinois economy designed specifically to address how tax changes affect economic activity. The State Tax Analysis

Modeling Program (STAMP) was first developed for Massachusetts in 1994. Fourteen states (Arizona, California, Maryland, Michigan, Minnesota, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Virginia and Alabama) have since employed the model.

At the core of the STAMP are two assumptions. First, households seek to maximize their utility. Simply put, a household bases how much time is spent for work and leisure based on its after-tax earnings. Second, firms seek to maximize profits. In order to maximize profits, businesses hire labor and invest in capital based on the cost (of both labor and capital) and on the state tax liability as a result of each action, among other variables.

Based on these principles, the Beacon Hill Institute (BHI) developed a structural model of the Illinois economy by compiling detailed base line data from 2001 and extrapolating it to FY04.

The data is organized into a Social Accounting Matrix, which in the case of Illinois, consists of a 77 by 77 matrix that accounts for the main economic and fiscal flows of the state. Each of these sectors is an aggregate group or a compilation of the segments of the economy. For the Illinois STAMP model, BHI separates households into seven income classes and firms into 27 industrial sectors.

A on direct-purchase natural gas	$42 million
Narrows the "rolling stock" exemption	$82 million
The net-operating loss deduction was limited	$10 million
A new tax was imposed for operations at the Industrial Commission	$27 million
The sales-tax exemption for pollution- tax control equipment was eliminated	$3 million
The Manufacturers Purchase Credit was eliminated	$20 million
The graphic arts machinery and equipment exemption was eliminated	$4 million
The sales-tax exemption machinery and equipment used for oil and coal exploration and production was eliminated	$1 million
The death tax was reinstated	$45 million
The credit for personal-property replacement tax was eliminated	$7 million
The income-tax credit for training expenses was eliminated	$15 million
The research and development tax credit was eliminated	$15 million
Various environmental fees were raised for air, water and construction permits	$60 million
The corporate income tax deduction was eliminated	$5 million
Corporate franchise taxes were hiked	$5 million
Increased Casino Taxes	$200 million
Total:	**$541 million**

Figure 1

In addition, BHI distinguishes between 21 types of taxes and 13 categories of spending. To complete the model there are two factor sectors -- labor & capital – comprising of an investment sector, five state fund sectors and one sector to represent the rest of the world.

To measure the effects of changes in tax policy, the model uses a Microsoft Excel interface to enter the desired change in taxes, either as a percentage or dollar amount, and then computes and compares the baseline (the original budget) to the computer generated changes (the proposed budget).

The FY04 Budget, as passed by the General Assembly and signed by Governor Blagojevich, attempted to close a $5 billion gap. This budget included an anticipated $541 million from business tax and fee increases, $230 million in state asset sales and $350 million from the 10th casino license still held by the state (and currently held up in litigation).

To date, the $580 million from the proposed sale of state assets and the 10th casino license has yet to emerge, which suggests that the General Assembly may have to readdress the budget.

This analysis dynamically scores the $541 million in new taxes and fees imposed on the state's business community thus gauging the impact on job creation, investment and personal income. Figure 1 lists the tax increases and fees passed on to private sector by the General Assembly.

The Results

Employment	Jobs	Jobs
Number of jobs		
Change in employment	6,047,403	6,043,580
% change in employment	-	**-3,823**
relative to baseline	-	-0.06%
Gross wage rates	$/wkr/yr	$/wkr/yr
Baseline wage rate, $/person/yr, nominal $	42,061.00	42,053
Change in wage rate, nominal $	-	**-8**
% change in wage rate relative to baseline	-	-0.02%
Investment	$m	$m
Baseline investment, $m, nominal $	61,380.219	61,269.853
Change in nominal investment ($m)	-	**-110.366**
% change in capital stock relative to baseline	-	-0.18%
State Personal Income, nominal	$bn	$bn
SPI ($bn)	464.183	463.915
Change in nominal SPI ($bn)		**-0.268**
% change in nominal		-0.06%
Disposable Income, real	$bn	$bn
DI ($bn)		336.377
Change in real DI ($bn)	336.828	**-0.451**
% change in real DI		-0.13%
Disposable Income per capita, real	$	$
DI/capita ($)	27,560	27,529
Change in real DI/capita ($)		**-30**
% change in real DI/capita		-0.109%

Decomposing effects of changes	$m
Change in State Funds	
of which:	**443.91**
Sales Tax	17.59
Business & Occupation Tax	54.96
Motor Fuels Tax	(0.98)
Real Estate Tax	27.18
State Personal Income Tax	(7.28)
State Cigarette Tax	(0.85)
State Property Tax	(1.64)
State Other Taxes	354.94
Change in taxes at the local level	
of which:	**(19.30)**
Local Residential Property Tax	(4.36)
Local Business Property Tax	(14.93)
Total tax change (state + local)	**424.61**

What is Happening Here?
This model is designed to estimate the effects of policy changes on the state's economy. There are thousands of equations built-in for each sector. Each is set to converge to general market equilibrium. For each change, as a result of the new or proposed policy, a calculation is made (based on the original weights and equations), allowing policy makers to study the effects of the change compared to the "baseline" case.

As our experiment involves various types of taxes and each act differently in the equations and in the overall economy, the effects are a bit more difficult to single out. In general, taxes are divided into sales or excise taxes, factor taxes, and household taxes.

Increases in factor taxes will have an impact on the production function (depending on the elasticities for different sector) making the factors more expensive in absolute terms and relative to each other. This will make the factor demand drop. Therefore 3,823 jobs will be lost while nominal investment will decrease (nominally) by $110 million. Furthermore, because prices will slightly increase, factor prices will drop due to lower demand. Consumption will also drop as people will have less disposable income but will continue to spend more for the same goods. As both labor and capital will be paid less, the real disposable income will drop by 0.13%, and overall state personal income will be 0.06% lower.

As domestic demand decreases, government demand will increase due the increased revenue available to the state and local governments to spend. Also, the government could now afford to employ more and support more social programs (in the form of transfer payments to low income groups); assuming the government will have the same spending pattern.

All of the above will have an effect on migration. The *behavior* of high-income households changes. Approximately 3,033 people will leave the state (1,052 households) in favor of other states with lower taxation and higher-income jobs. Increased availability of social programs will attract more low-income households into the state.

Conclusions on the State Tax Hikes
Overall, the model demonstrates negative changes to the state economy, although arguably not significant in comparison to the size of the state's economy. Some other interesting conclusions drawn from this analysis are:

- The only economic sector of the Illinois economy, out of 77 analyzed, that grows due to these changes in tax policy is state government. Critics of the governor contend that the state budget will increase state <u>spending</u> by $1 billion. The administration has denied this accusation; however, this analysis suggests that the critics be given credence.
- The $541 million in new taxes and fees will result in only $443 million in increased revenues – $94 million less than anticipated.

Property Tax – Income Tax Swap Proposals
Since 1994, Illinois legislators and policy experts have discussed property tax – income swap proposal schemes. Then, gubernatorial candidate Dawn Clark Netsch proposed such a measure during her unsuccessful bid for the governorship. In 1996, former Governor Jim Edgar, a harsh critic of the Netsch proposal offered one of his own. In 1998, then Democratic nominee for

governor Glen Poshard supported a property tax-income tax swap scheme in his unsuccessful bid for the governor's mansion.[1] Last year, the Education Funding Advisory Board, appointed by George Ryan, released its own tax swap proposal during the 2002 the gubernatorial campaign. Both nominees (Democrat Rod Blagojevich and Republican Jim Ryan) rejected the proposal.

This year, Cook County Assessor James Houlihan announced a plan that he estimates will generate $1.5 billion in new revenue for schools. The Center for Tax and Budget Accountability has also released a proposal of their own that builds upon the recommendations of last year's Economic Funding Advisory Board.[2]

While Governor Blagojevich has steadfastly stuck to his position of not raising general income or sales taxes, the tax swap issue may have found a new life when Senator Minority Leader Frank Watson (R-Greenville) told a suburban Chicago newspaper that the he was open to the idea of a tax swap.[3]

For the purpose of this study, the proposal put forth by the Center for Budget and Tax Accountability (CBTA) was used to study its impact on the Illinois economy. The Center for Budget and Tax Accountability's proposal called for a 25% percent reduction in local property taxes for schools in exchange for a broadening of the sales tax base; increasing corporate and personal income taxes and expanding the personal income taxes to include pensions and other transfers. All told, their proposal – on the high end – hikes taxes to a total of $7.04 billion in exchange for $3.24 billion in local property tax relief for residences and businesses.[4]

Results of Center for the Budget and Tax Accountability Proposal

Employment	Jobs	Jobs	**Decomposing effects of**	$m
Number of jobs	6,047,403	5,970,051	**changes**	
Change in employment	-	**-77,352**		
% change in employment			Change in State Funds	**6,904.02**
relative to baseline	-	-1.28%	*of which:*	
			Sales Tax	2,267.99
Gross wage rates	$/wkr/yr	$/wkr/yr	Business & Occupation Tax	428.81
Baseline wage rate,			Motor Fuels Tax	(11.42)
$/person/yr, nominal $	42,061.00	42,306	Real Estate Tax	(10.87
Change in wage rate,	-		State Personal Income Tax	4,251.73
nominal $		**245**	State Cigarette Tax	(12.41)
% change in wage rate	-		State Property Tax	15.64
relative to baseline		0.59%	State Other Taxes	(25.45)
Investment	$m	$m	Change in taxes at the local level	
Baseline investment, $m,			*of which:*	**(4,853.48)**
nominal $	61,380.219	62,309.937	Local Residential Property Tax	(2,830.06)
Change in nominal			Local Business Property Tax	(2,023.42)
investment ($m)	-	**929.719**	Total tax change (state + local)	**2,050.54**
% change in capital stock				
relative to baseline	-	1.51%		

State Personal Income, nominal	$bn	$bn		
SPI ($bn)	464.183	465.007		
Change in nominal SPI ($bn)		**0.824**		
% change in nominal		0.18%		
Disposable Income, real	$bn	$bn		
DI ($bn)	336.828	333.563		
Change in real DI ($bn)		**-3.265**		
% change in real DI		-0.98%		
Disposable Income per capita, real	$	$		
DI/capita ($)		27,368		
Change in real DI/capita ($)	27,560	**-189**		
% change in real DI/capita		-0.696%		

The Devastating Effects of the Income Tax – Property Tax Swap

The first, and most obvious, effect of this proposal is the loss of jobs. A tax swap proposal at or near the level called for by the Center for Budget and Tax Accountability would result in 77,352 jobs lost, or 1.28% increase in unemployment to the baseline. Furthermore, just as the governor's business tax hikes fall short, so do the projections of raising $7.04 billion in new state revenue. Under this proposal, the tax swap falls short by $147 million. The overall impact on the Illinois economy moves in much the same direction as the FY 2004 budget, but a tax swap of this magnitude is a far more severe threat to the Illinois economy.

Unlike the FY 2004 budget, the burden for filling state coffers for education is shifted from large enterprises on to individuals and small businesses. Large enterprises, seeking to maximize profits, can take advantage of the new tax climate by shifting costs to avoid higher corporate income taxes, while their property taxes are reduced. For instance, at the national level, large corporations can reduce the amount of income liable for taxation by shifting the money into capital investment or booking investment as a "loss" of revenue. Evidence of this kind of reaction comes from the rise in net capital investment of $929,719 million, while employment, Gross State Product, and income fall.

Smaller enterprises such as eating and drinking establishments as well as personal and mechanical services lose under this proposal because their sectors lack the elasticities of larger firms. Labor, now being taxed more, would also suffer losses totaling $2.1 billion while capital earnings show $631 million in gains. Note that nominal wages will rise by $245 but that will reflect paying those fortunate to keep their jobs more so they are able to pay the higher tax rates. The Gross State Product would shrink by .93% or by $4.3 billion.

Along with job losses and a reduction in GSP, prices will slightly increase, the factor prices will drop (due to lower demand) and the consumption will also drop as people will gain less but spend more for the same goods. As both labor and capital will be paid less, the real disposable income will drop by 0.98%, or $3.265 billion and overall state personal income per capita will be 0.69% lower, or $189.

All of the above will have an effect on migration, as the high income households will start to leave the state in droves – 35,101 people leave Illinois (13,331 households) in favor of other states with less taxation under this proposal. Low income households might migrate into Illinois for the added social benefits that increase $2.050 billion in new state and local tax revenue emerges.

Conclusions from Property Tax – Income Tax Swaps
In 2002, Illinois led the United States in total manufacturing jobs lost (67,000). Under the proposed property tax – income tax swap by the Center for Budget and Tax Accountability, it would be reasonable to conclude that the state economy would suffer more.

Other conclusions we can draw from this simulation are:

- Property tax – Income tax proposals will shift the burden of funding state government from larger firms to small businesses and individuals.
- Under this proposal, state personal income tax and sales and use tax collections would rise by $6.514 billion. Local residential property taxes would only be reduced by $2.83 billion. In reality, this is not a "swap" but a net tax increase.
- Business and occupation tax collections would rise by $427 million while local property business taxes would be reduced by $1.946 billion.

Recommendations
Clearly, the state tax policy changes implemented in the FY04 budget have had a negative impact on the Illinois economy. The FY 2004 budget, while not raising general income and sales taxes, did raise taxes and fees on businesses by about $341 million according Senate Bill 1903 – now Public Act 93-0032. In addition, the state raised taxes on the casino industry originally designated to bring $200 million. The Economic and Fiscal Commission has already lowered that estimate to $175 million.

This formal model shows that when supply equals demand; households maximize their after tax income and firms maximize profits that the FY04 business tax and fee hikes fall short by close to $100 million; costing the state approximately 3,800 jobs and reducing investment by $110 million. In the real world, where individuals and firms make errors, the repercussions of these $541 million in business fee and tax hikes could be greater.

The obvious recommendation here is to reduce state government spending. Earlier this year, as part of the President's Economic Growth and Jobs program Illinois received $422 million in "free" money from the Federal Government. At that time, the Illinois Policy Institute recommended (along with a number of other groups) that the governor use that money to help offset the business tax and fee hikes. Since then, Comptroller Daniel Hynes used the first installment of those funds to pay overdue Medicaid bills while the General Assembly, the people's elected representatives, has yet to weigh in on this issue. We ask that they do so now.

Those monies could be used to offset $422 million of the $541 million in fee and tax hikes leaving $119 million in lost revenue out of a $23 billion General Revenue Fund.[5]

With regard to the property tax – income tax swap proposals circulating around the state legislature, we urge that proponents go back to the drawing board. A property tax – income tax swap shifts the burden from large firms to individuals and small businesses. Moreover, any economic policy that costs the state more than 77,000 jobs is a political non-starter.

The Illinois Policy Institute, after running the numbers through the Illinois-STAMP, believes that the governor is on firm economic ground by resisting these efforts and urges the General Assembly leadership to do the same.

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[1] Shoffner, Karen. "School Funding Meet With Skepticism" Pioneer Press. October 16, 2003

[2] See "Funding a Quality of Education Requires Fiscal Reform." Center for Tax And Budget Accountability. http://www.ctbaonline.org/.

[3] Krol, Eric. "GOP Leader Accuses Governor of Requital." *Daily Herald*. September 10, 2003

[4] Ibid.

[5] FY 2004 Budget