Economic Impact of Taxing Professional Services in Illinois

BY ALEX BRILL

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EXECUTIVE SUMMARY

Fiscal strain to the Illinois budget, including declining revenues in the current fiscal year, have fueled debate in Springfield about potential sources of additional tax revenue. One proposal that has been floated several times is to extend the state sales tax to professional services. This policy would have negative economic consequences across the state's economy because a professional services tax is primarily a business-to-business tax.

Business-to-business taxation harms not only the taxed firms and their clients, but also support staff, vendors to these firms, landlords, and the state economy broadly. To arrive at an empirical estimate of the negative impact in Illinois of a professional services tax, we model such a tax on eight select professional service industries: insurance agents, real estate agents, legal services, accounting, architecture, computer systems design, management consulting, and advertising. For five of the industries—management consulting, advertising, architecture, accounting, and computer systems design—businesses represent between 90 and 100 percent of the demand for services.

Employment Impact

As the accompanying table shows, taxing these eight professional service industries would cause a first-year decline of 30,000 jobs in Illinois. The negative employment effect expands over time and reaches more than 50,000 in 2022. It is important to note that the biggest negative impact of a professional services tax is not on the taxed industries themselves.

The five industries with the most job loss as a result of this tax would be construction, retail trade, food services and drinking places, securities and other financial investment and related services, and offices of health practitioners. Those five industries account for 43 percent of the total projected job loss.

Output Impact

In 2022, Illinois could expect a decline in GDP of $5.6 billion as a result of the tax.

Disposable Personal Income Impact

Illinois residents would see a steady decline in disposable personal income—that is, after-tax income—as a result of the professional services tax. In 2022, individuals in Illinois would collectively have $5 billion less to spend or save.

Economics tells us that business-to-business taxation is bad tax policy. As our analysis shows, a sales tax on professional services in Illinois would hamper the Illinois economy and hurt not only those working in professional service industries, but also tens of thousands of other workers and Illinois residents.

IMPACT OF PROFESSIONAL SERVICES TAX ON PRIVATE NON-FARM EMPLOYMENT, 2017–2022

	2017	2018	2019	2020	2021	2022
Professional Services	-3,972	-5,160	-6,069	-6,743	-7,245	-7,619
Top 5 Industries	-12,796	-17,041	19,894	-21,671	-22,698	-23,193
All Other Industries	-13,231	-16,616	-19,161	-20,956	-22,212	-23,074
Total Employment Impact	**-30,000**	**-38,817**	**-45,124**	**-49,371**	**-52,156**	**-53,886**

Economic growth in Illinois has underperformed the broader US economy for well over a decade. Illinois's gross domestic product (GDP)—that is, the value of total economic production—was virtually unchanged from 2006 to 2014, while the US private-sector economy expanded 7 percent.[1] Stagnant growth has resulted in net outbound migration and severe strains on the state's fiscal condition. In fiscal year (FY) 2014, state revenues increased 1.2 percent, less than the state's nominal GDP growth and less than the increase in state spending. In FY 2015, tax collections fell 2.4 percent, and current projections for FY 2016 show a further decline in tax receipts of 11.6 percent.[2] In April 2016, personal income tax receipts were down 28.9 percent from where they were in April 2015, while total state tax collections were down 20.9 percent.[3]

These trends have fueled debate in Springfield about potential sources of additional tax revenue. While Governor Bruce Rauner did not include a professional services tax in his 2017 state budget, he has previously proposed broadening the state sales tax to include professional services and has explicitly advocated for tax reform to address the state's "antiquated tax system whose base is too narrow."[4]

This report examines the economic impact of a state sales tax on professional services in Illinois. In general, a tax on professional services represents a significant business-to-business tax because the majority of professional services are provided to businesses (as opposed to households). The harmfulness of business-to-business taxation is well documented in the economic literature, as we establish below. We then focus on the empirical impact of such a tax in Illinois, using a commercial economic forecasting model.

ILLINOIS ECONOMIC THUMBNAIL

The economic performance of the Illinois economy is the weakest in the Midwest. Total employment (6.2 million) is at the same level as it was in July 2008, and the unemployment rate was 6.5 percent in March 2016, 1.5 percentage points higher than the US national average. As Moody's Analytics noted recently in a report for the State of Illinois Commission on Government Forecasting and Accountability, "Illinois has added fewer jobs than any neighboring state this year despite being the most populous in the region."[5] While Illinois is ranked fifth in the United States by aggregate personal income and state GDP, personal income growth and economic growth in the state are lagging the rest of the country.[6]

The professional services sector in Illinois, which generated $55 billion in annual output in 2015, has barely returned to its 2008 level, after adjusting for inflation. But Moody's forecasts predict that the sector will be a relatively good performer within the Illinois economy under current fiscal policy assumptions, with most of the growth concentrated in and near Chicago.[7]

However, subjecting professional services to the state sales tax—as has been proposed on several occasions—would change the prospects of the professional services sector and negatively impact the Illinois economy generally.

THEORETICAL CONSEQUENCES OF TAXING PROFESSIONAL SERVICES

Illinois is one of 45 states that impose a state sales and use tax. Rates on these taxes range from 2.9 percent (Colorado) to 7.5 percent (California). In Illinois, the state sales tax rate is 6.25 percent. The Illinois state sales and use tax generally applies to goods sold to consumers. The sales tax is imposed at the point of sale (the store), and the use tax is owed by any Illinois resident who purchases goods out of state and brings them home. Certain consumer goods, such as food sold at grocery stores and prescription and nonprescription medicines, are exempt from sales tax. Soda, candy, food purchased at a restaurant, software, and most other tangible property are subject to tax. These products are generally purchased by consumers, not businesses. As such, the tax is imposed at the point of *final* sale to the consumer.

Excluded from the sales tax are personal services such as home repair services, hairdresser and barber shop services, and laundry and dry cleaning services. Also excluded are professional services such as legal services, accounting, architectural design, etc. The logic for excluding *professional* services is the same as the logic for not imposing a sales tax on raw steel or factory machines—they are business-to-business sales or *intermediary* goods.

Taxing business-to-business sales causes a number of economic distortions. Alan Viard, an economist at the American Enterprise Institute, observes that such a tax 1) distorts business decisions and encourages firms to choose inputs that are exempt from tax; 2) causes firms to outsource fewer services and vertically integrate more processes because "in house" activities are not subject to tax; and 3) causes "pyramiding," whereby a sales tax can be imposed repeatedly on the same component of a final good.[8] For example, if the inputs into a consumer good (which is subject to a sales tax) includes as an input goods and services that were taxed when purchased by the manufacturer, those goods or services are effectively double taxed. Economist Raymond Ring estimates that about 40 percent of sales tax payments nationally were imposed on business purchases.[9]

Assessing the pros and cons of expanding the sales tax base, economists from Ernst & Young observe:

> Most economists would agree that [there] are important potential benefits if the sales tax base expansion is limited to services purchased primarily by households as final consumers. This critical qualification appears to have been lost in the process of designing recent sales tax reform proposals. To the extent that services are primarily consumed by business, such as professional services, including these business-to-business sales in the sales tax base will have a significant negative consequence.[10]

In short, a professional services tax is first and foremost a business-to-business tax. And a business-to-business tax has a dramatically different (and more punitive) effect than a retail sales tax or even other types of service taxes that are imposed only on households. We next quantify the negative impact of a professional services tax on Illinois's economy using a macroeconomic model of the state economy.

MACROECONOMIC ANALYSIS OF A PROFESSIONAL SERVICES TAX IN ILLINOIS

Business-to-business taxation harms not only the taxed firms and their clients, but also support staff, vendors to these firms, landlords, and the state economy broadly. To arrive at an empirical estimate of the negative impact in Illinois of a professional services tax, we model such a tax on select professional service industries using a model of the Illinois economy built by and leased from the well-regarded and widely known Regional Economic Models, Inc. (REMI).

The REMI model measures a wide spectrum of economic impacts arising from the change in behavior that would result from the increase in the price of professional services that a tax on these services would induce. (For more on the REMI model, please see www.remi.com/the-remi-model.) This report focuses specifically on the impact of the tax in the following categories:

- Employment,
- Output (or GDP) within the state of Illinois,
- Disposable personal income of state residents.

Key Assumptions

How broadly Illinois may apply a professional services tax remains to be seen. For the purposes of our analysis, we assume that the following eight industries would be subject to the 6.25 percent sales tax beginning on January 1, 2017. We identify the industries below by their North American Industry Classification System (NAICS) code, which is the standard that federal statistical agencies use and that the REMI model uses.

1. Insurance Carriers (NAICS 5241)
2. Real Estate (NAICS 531)
3. Legal Services (NAICS 5411)
4. Accounting, Tax Preparation, Bookkeeping, and Payroll Services (NAICS 5412)
5. Architectural, Engineering, and Related Services (NAICS 5413)
6. Computer Systems Design and Related Services (NAICS 5415)
7. Management, Scientific, and Technical Consulting Services (NAICS 5416)
8. Advertising and Related Services (NAICS 5418)

TABLE 1. BUSINESS VS. HOUSEHOLD CONSUMPTION OF EIGHT PROFESSIONAL SERVICES

PROFESSIONAL SERVICE INDUSTRIES	2017 IL Output ($ Billions)	Share Consumed by Businesses	Share Consumed by Households
Management, scientific, and technical consulting services	$12.6	100%	0%
Advertising and related services	$8.1	99%	1%
Architectural, engineering, and related services	$8.1	95%	5%
Accounting, tax preparation, bookkeeping, and payroll services	$6.8	91%	9%
Computer systems design and related services	$12.8	90%	10%
Legal services	$10.6	64%	36%
Insurance carriers	$0.9	45%	55%
Real estate	$4.0	32%	68%

As noted above, professional services are largely used by businesses, and this holds true for the industries in our analysis. **Table 1** provides both the output and the breakdown between household and business demand for services for each of the eight industries. For five of the industries—management consulting, advertising, architecture, accounting, and computer systems design—businesses represent between 90 and 100 percent of the demand for services. Even for the industry with the lowest share of business consumption (real estate), business-to-business activity accounts for approximately a third of services.

In our analysis, we assume that, in addition to applying to professional services provided by Illinois professionals to in-state customers, the tax will apply to "imported" professional services (that is, professional services purchased by an Illinois-based customer from an out-of-state professional). Illinois already has a use tax, which requires consumers to pay sales tax on items purchased out of state and brought into Illinois. Because there is precedence in Illinois for taxing imports this way, we consider it likely that Illinois's use tax would be extended to professional services should they be subject to the state sales tax.

For realtors and insurance agents, we applied the tax only to commissions, which we estimated at 5 percent of each industry's gross revenue. In the real estate industry, we included rental of tenant-occupied nonfarm housing. In the insurance industry, we excluded health insurance.

Results

The results of our analysis show that, should Illinois impose a sales tax on professional services, the state should expect negative economic consequences across the board. Below, we focus on the effects of a professional services tax on employment, output (or GDP), and disposable personal income.

Employment

A tax on the eight professional service industries identified above would cause a first-year decline of 30,000 jobs in Illinois. The negative employment effect expands over time and reaches more than 50,000 in 2022. **Table 2** offers a breakdown of the employment impact on the eight taxed industries, the top five industries by job loss, and all other industries. It is important to note that because of the interconnectedness of the economy, a tax's impact is not limited to taxed industries. In fact, the consequences of a tax can be greater downstream than for the industries subject to the tax. This is true in the case of a professional services tax, where the biggest negative impact is not on the taxed industries themselves. Construction and retail trade would suffer more than any other industry in Illinois, with more than 4,000 jobs lost in each industry in the first year. By 2022, construction employment, an industry where nearly 2 out of every 5 workers is a union member,[11] would experience job loss of more than 8,000.

TABLE 2. IMPACT OF PROFESSIONAL SERVICES TAX ON PRIVATE NON-FARM EMPLOYMENT, 2017–2022

	2017	2018	2019	2020	2021	2022
8 TAXED PROFESSIONAL SERVICE INDUSTRIES						
Real estate	-1,122	-1,375	-1,566	-1,690	-1,768	-1,814
Legal services	-967	-1,074	-1,153	-1,210	-1,251	-1,278
Accounting, tax preparation, bookkeeping, and payroll services	-416	-532	-619	-685	-733	-769
Management, scientific, and technical consulting services	-378	-582	-744	-873	-976	-1,058
Computer systems design and related services	-358	-579	-760	-910	-1,038	-1,148
Architectural, engineering, and related services	-343	-552	-702	-811	-891	-950
Insurance carriers	-272	-306	-332	-347	-353	-354
Advertising and related services	-116	-160	-193	-217	-235	-247
Subtotal – Professional Services	**-3,972**	**-5,160**	**-6,069**	**-6,743**	**-7,245**	**-7,619**
5 TOP INDUSTRIES BY JOB LOSS						
Construction	-4,281	-6,555	-7,812	-8,395	-8,538	-8,395
Retail trade	-4,031	-4,729	-5,295	-5,696	-5,972	-6,147
Food services and drinking places	-1,736	-2,216	-2,630	-2,963	-3,230	-3,442
Securities and other financial investments and related activities	-1,546	-2,207	-2,718	-3,104	-3,394	-3,607
Offices of health practitioners	-1,203	-1,334	-1,439	-1,512	-1.564	-1,602
Subtotal – Top 5 Industries	**-12,796**	**-17,041**	**-19,894**	**-21,671**	**-22,698**	**-23,193**
ALL OTHER INDUSTRIES	**-13,231**	**-16,616**	**-19,161**	**-20,956**	**-22,212**	**-23,074**
Total Employment Impact	***-30,000***	***-38,817***	***-45,124***	***-49,371***	***-52,156***	***-53,886***

Chart 1 shows at a glance the impact of the tax on employment compared with what employment in Illinois is expected to be without the tax. This starkly illustrates the outsized indirect effect —that is, the effect on industries not subject to the new tax.

CHART 1. IMPACT OF PROFESSIONAL SERVICES TAX, 2017-2022

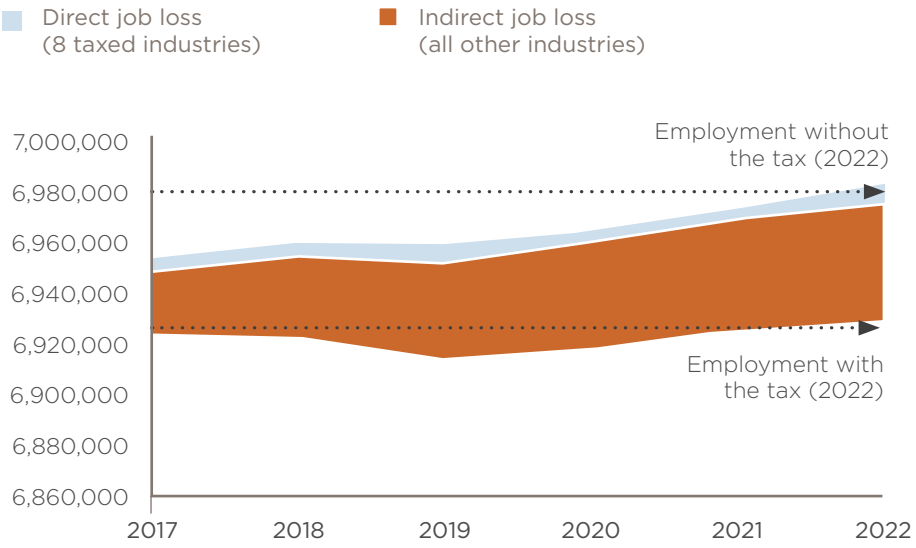
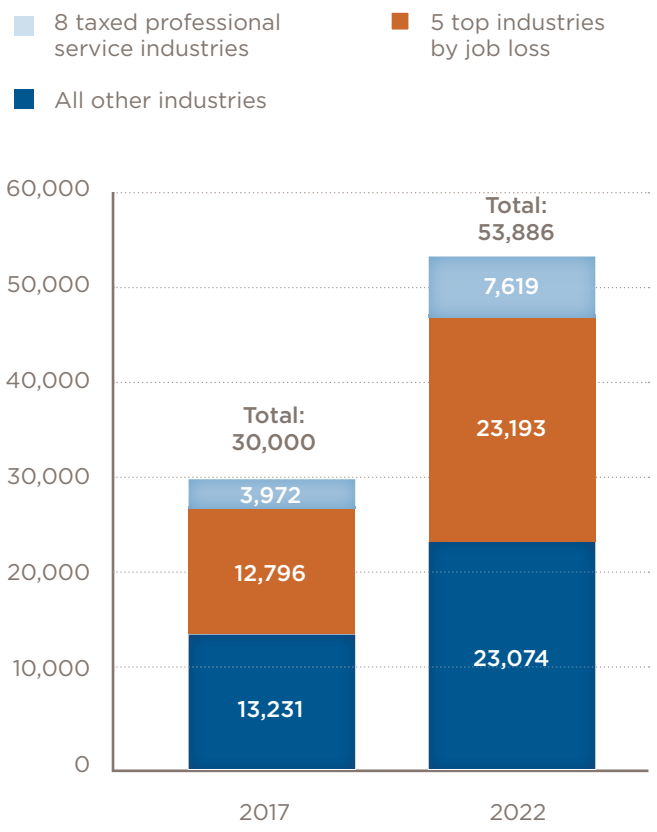


Chart 2 illustrates the increasingly negative impact of the tax from 2017 (the year it is assumed to take effect) to 2022. The employment impact remains constant across the three categories, with the eight taxed industries accounting for 14 percent of the total job loss, the top five industries by job loss accounting for 43 percent, and all other industries accounting for 43 percent.

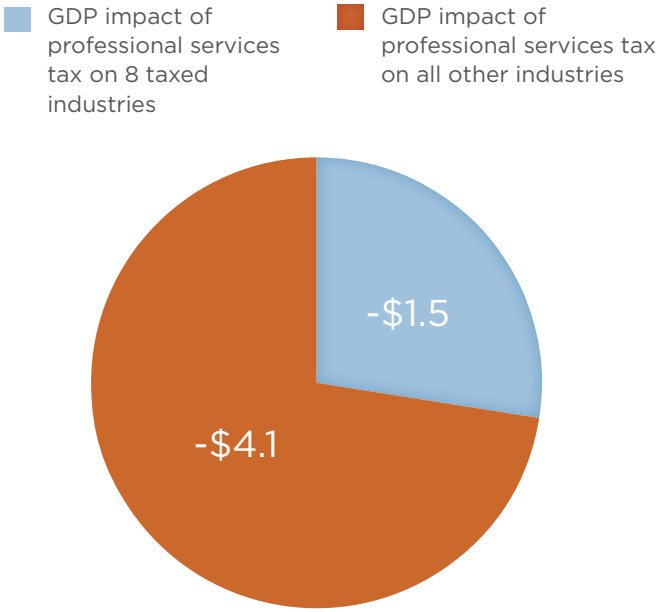
CHART 2. BREAKDOWN OF PRIVATE NON-FARM JOB LOSS, 2017 AND 2022



Output

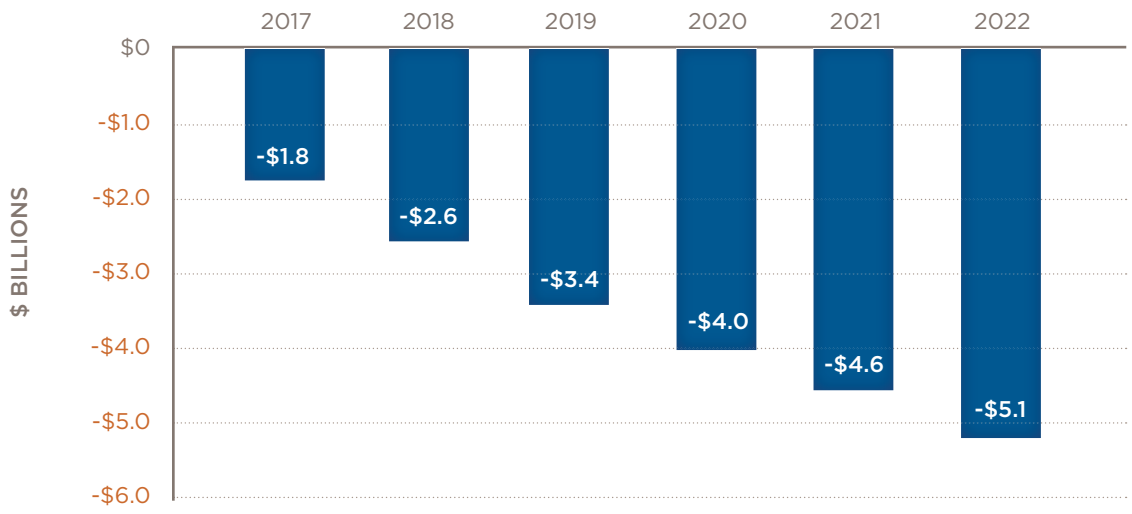
In 2022, Illinois could expect a decline in GDP of $5.6 billion as a result of the tax (see **Chart 3**). It is noteworthy that the GDP impact on the eight taxed industries is larger than the employment impact on the taxed industries. The eight industries' cumulative drop in output represents roughly one-quarter of the total drop in output in 2022, whereas the eight industries' cumulative job loss represents just 14 percent of the total employment impact in 2022. This finding is indicative of the relatively high labor productivity of the taxed industries.

CHART 3. IMPACT OF PROFESSIONAL SERVICES TAX ON GDP, 2022 ($ BILLIONS)



TOTAL GDP IMPACT IN 2022: -$5.6 BILLION

CHART 4. DECREASED DISPOSABLE PERSONAL INCOME DUE TO PROFESSIONAL SERVICES TAX, 2017–2022



Disposable Personal Income

Chart 4 shows the steady decline in Illinois residents' disposable personal income—that is, after-tax income—as a result of the professional services tax. In 2022, individuals in Illinois would collectively have $5 billion less to spend or save.

CONCLUSION

The macroeconomic analysis presented in this report substantiates the economic theory that tells us that business-to-business taxation is bad tax policy. As our analysis shows, a sales tax on professional services in Illinois would hamper the Illinois economy and hurt not only those working in professional service industries, but also tens of thousands of other workers and Illinois residents.

NOTES

[1] Bureau of Economic Analysis regional GDP data.

[2] Office of the Governor, *Illinois State Budget Fiscal Year 2017* (February 17, 2016), 70–71, available at www.illinois.gov/gov/budget/Documents/Budget%20Book/FY%202017%20Budget%20Book/FY2017OperatingBudgetBook.pdf (accessed May 16, 2016).

[3] Commission on Government Forecasting and Accountability, "Monthly Briefing for the Month Ended: April 2016," 6, available at http://cgfa.ilga.gov/Upload/0416revenue.pdf (accessed May 16, 2016).

[4] Bruce Rauner, State of the State Speech, February 4, 2015, available at www.governing.com/topics/politics/gov-illinois-bruce-rauner-speech.html (accessed May 16, 2016).

[5] Moody's Analytics, *State of Illinois Economic Forecast* (February 2016), available at http://cgfa.ilga.gov/Upload/2016MoodysEconomyILforecast.pdf (accessed May 16, 2016).

[6] Bureau of Economic Analysis, personal income data published March 24, 2016.

[7] Moody's Analytics, *State of Illinois Economic Forecast*.

[8] Alan D. Viard, "Sales Taxation of Business Purchases: A Tax Policy Distortion," *State Tax Notes*, June 21, 2010, available at www.aei.org/wp-content/uploads/2011/10/ViardTaxNotes062110.pdf (accessed May 16, 2016).

[9] Raymond L. Ring Jr., "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal* 52, no. 1 (March 1999): 79–90.

[10] Robert Cline, Andrew Phillips, and Tom Neubig, "What's Wrong with Taxing Business Services: Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services," April 4, 2013.

[11] Frank Manzo IV, Robert Bruno, and Virginia Parks, *The State of the Unions 2015: A Profile of Unionization in Chicago, in Illinois, and in America* (May 18, 2015), available at http://illinoisepi.org/countrysidenonprofit/wp-content/uploads/2013/10/State.of_.the_.Unions.2015_ILEPI.LEP_.SSA_.pdf (accessed May 16, 2016).

About the Author

Alex Brill is the CEO of Matrix Global Advisors, an economic consulting firm. He is also a research fellow at the American Enterprise Institute and served as an advisor to the Simpson-Bowles Commission. Previously, he was chief economist and policy director to the House Ways and Means Committee. Prior to his time on the Hill, he served on the staff of the President's Council of Economic Advisers.

About Matrix Global Advisors

Matrix Global Advisors (MGA) is a Washington, DC–based economic policy consulting firm that was founded by Alex Brill in 2007. MGA engages in consulting and analysis on a range of tax, health care, and other policy matters. Through knowledge of the legislative and regulatory process and the application of analytical tools, MGA has advised and conducted analyses for health insurers, hospitals, drug manufacturers, trade associations, investment banks, and others. MGA has also conducted numerous economic impact assessments and economic footprint analyses.

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MATRIX GLOBAL ADVISORS

1350 Connecticut Avenue, NW Suite 610 Washington, DC 20036 | 202-558-7159 | info@matrixglobaladvisors.com www.matrixglobaladvisors.com