

A stylized, light blue line-art map of the Chicago street grid is overlaid on the left side of the cover. The map shows a dense network of streets, with major thoroughfares and highways highlighted in a slightly darker shade. The map is set against a solid blue background that features faint, horizontal white lines.

# The Economic Consequences of a Professional Services Tax in Chicago

**BY ALEX BRILL**

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The City of Chicago is entering fiscal year (FY) 2020 facing a projected budget shortfall of \$838.2 million. Following seven years of improvement in the annual deficit and a slight surplus in FY 2019, the projected deficit is the result of increased spending across major budget categories. The two largest increases are \$277 million in additional pension obligations and \$312 million in additional personnel and benefit costs. The large deficit is projected to persist in future years.

First-term mayor Lori Lightfoot has indicated that she would like to ask state lawmakers in Springfield to allow her to address these budget challenges with a new tax on certain professional service providers in Chicago. This idea is one of the worst ways to generate new revenue for the city because a tax on professional services risks distorting business decisions and pushing valuable business activity outside the city limits. Ultimately, the economic burden of such a tax will be felt in a variety of ways by the city and its residents. This article delineates these consequences.

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## Origins of a Professional Services Tax

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“One of the things I propose is a tax on high-end law firms, accounting firms . . . not on the little guys or the solo practitioners or small CPA firms, but a firm like mine, which is a large international law firm. Putting a small fee on the invoices they send their clients will barely be noticed, but yet could generate hundreds of millions of dollars in revenue.”

— LORI LIGHTFOOT, MARCH 24, 2019

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A proposed tax on large professional service firms like law firms and accounting firms was first floated by Lori Lightfoot while she was campaigning for mayor. The proposal has been thin on details, but the now-mayor has suggested that the tax could raise tens of millions of dollars per year, or far more. For example, she told the *Crain's Chicago Business* editorial board that the tax could raise “around \$100 million a year,”<sup>1</sup> and she told WGN-AM 720's *Sunday Spin* listeners that the tax could yield “hundreds of millions of dollars of revenue.”<sup>2</sup> Mayor Lightfoot has indicated that if such a policy were to be enacted, it would exempt solo practitioners and small businesses in these fields, but the threshold has not been defined.

<sup>1</sup> Joe Cahill, “Where's the Will on Taxing Services, Mayor?” *Crain's Chicago Business*, July 2, 2019.

<sup>2</sup> Bill Ruthhart, “Lori Lightfoot Floats Tax on High-End Law, Accounting Firms to Help Plug Chicago's Budget Hole,” *Chicago Tribune*, March 14, 2019.

The notion of a tax on professional services in Chicago is not an idea original to Mayor Lightfoot. Her predecessor, Rahm Emanuel, campaigned on a similar idea in 2011. In fact, his opponent dubbed it the “Rahm tax,” but Emanuel never actively pursued it as mayor. At the state level, lawmakers have contemplated a tax on professional services, including in Illinois.

These proposals are often framed as an extension of the existing sales tax to a segment of the economy that can afford to pay a bit more. As such, the proposals often set the tax rate on professional services at the same rate applied to restaurants and other taxed goods. In Chicago, the city-level sales tax rate is 1.25 percent, but the total sales tax rate — including state, county, city, and transit authority taxes — is 10.25 percent. This combined rate ranks Chicago first in the country for highest sales tax rates, alongside Glendale, CA, and Long Beach, CA.<sup>3</sup>

<sup>3</sup> Jared Walczak and Dominic Pino, “Sales Tax Rates in Major Cities, Midyear 2019,” *Tax Foundation*, August 14, 2019.

# Economic Consequences of a Professional Services Tax

## DISTORTIONS AND INEFFICIENCIES

The political rhetoric in support of a tax on professional services often portrays it as a matter of equity – that is, if retail shops and restaurants are subject to a sales tax, it is only fair that law, accounting, and other professional service firms are taxed in a similar manner. Economists know this to be flawed logic that, if pursued, will impose unnecessary distortions and misallocations in the economy. This is because sales taxes, which are common in most states as well as many cities, should be applied to *final sales* to consumers and not to *intermediate sales*, often called business-to-business sales. In brief, a tax imposed on business-to-business transactions will:

- Distort business decisions and encourage firms to choose inputs that are exempt from tax;
- Cause firms to outsource fewer services and vertically integrate more processes because “in house” activities are not subject to tax; and
- Cause “pyramiding,” whereby a sales tax is imposed repeatedly on the same component of a final good.<sup>4</sup>

A professional services tax should be understood foremost as a business-to-business tax. For example, in the state of Illinois, more than 90 percent of accounting, tax preparation, bookkeeping, and payroll services — all forms of professional services — are provided by businesses to businesses, while 95 percent of architectural, engineering, and related services are business-to-business sales. Imposing a tax on these transactions is akin to the government pushing businesses to do business differently, to reorganize or to layer taxes on top of taxes as various companies provide inputs into the development and production of final retail goods.

<sup>4</sup> For additional detail on these factors, see Alan D. Viard, “Sales Taxation of Business Purchases: A Tax Policy Distortion,” State Tax Notes, June 21, 2010.

## ECONOMIC COSTS

A professional services tax is not just bad economic theory; it makes for bad economic outcomes. If Chicago were to impose a tax on professional service providers, even one targeted only at larger businesses, these companies would have a strong incentive to pursue a host of strategies to avoid the tax. This would result not only in lower revenues than expected, but also in real economic costs.

If the city of Chicago were to enact the professional services tax envisioned by Mayor Lightfoot, at least three responses by large law and accounting firms are likely, all of which would be a detriment to the Chicago economy:

1. Firms subject to the new tax will shift any expansion plans outside of Chicago. Likewise, existing large firms without a Chicago presence will hesitate to relocate to or open offices in Chicago.
2. Smaller firms fearing that their growth may subject them to the tax will also be encouraged to expand only outside of Chicago.
3. New small firms will hesitate to locate in Chicago for fear that they will grow to the point that they will be subject to the tax or that the tax will be expanded in the future to cover more businesses.

The consequence of fewer attorneys and accountants in Chicago may seem trivial to those outside of these professions, but the reality is that a policy that discourages these practitioners from working in Chicago will have a broader effect across the city. Large professional service firms employ a wide range of personnel. For example, a large survey of law firms revealed that on average there are more non-lawyers employed in a law firm than lawyers.<sup>5</sup> This means that a professional services tax in Chicago would also negatively affect assistants, billing staff, human resources personnel, and others in support roles at law firms and accounting firms.

<sup>5</sup> The National Law Journal and ALM Legal Intelligence, Survey of Law Firm Economics, 2012 Edition.

Chicago's largest professional service providers are also major real estate tenants and spend millions of dollars on local vendors. As they reallocate their resources outside of Chicago, those economic activities will migrate away too.

To understand the extensive impact of this type of policy, see the accompanying box highlighting an analysis of the economic consequences of a

hypothetical professional services tax in the state of Illinois. Besides the significant losses in jobs, output, and income from the tax, a startling finding of the Illinois analysis is that the top three industries by job loss are not professional services industries, but rather construction, retail trade, and food and beverage services. This illustrates the ripple effect of the tax throughout the economy.

## CASE STUDY:

# Macroeconomic Impact of a Professional Services Tax in Illinois

An analysis of a hypothetical professional services tax using an input-output model specific to Illinois quantifies the ripple effects this type of tax would have on the Illinois economy.<sup>1</sup> Using a model built by Regional Economic Models, Inc. (REMI), the analysis estimates the impact of a 6.25 percent professional services tax applied to eight industries:



Accounting, tax preparation, bookkeeping, and payroll services



Advertising and related services



Architectural, engineering, and related services



Computer systems design and related services



Insurance carriers



Legal services



Management, scientific, and technical consulting services



Real estate

Following implementation of the tax, Illinois would see a decline in jobs, gross domestic product (GDP), and disposable personal income (that is, after-tax income). Specifically, by the fifth year of the tax, Illinois could expect a decline in GDP of \$5.6 billion, and Illinois residents would collectively have \$5 billion less to spend or save. Job losses would total nearly 54,000. Notably, none of the taxed industries rank among the hardest hit in terms of employment – the three industries experiencing the most employment losses would be construction, retail trade, and food and beverage services, illustrating the far-reaching effects of the tax.

Mayor Lighfoot's version of a professional services tax is too vague to model explicitly at this time, but the expected impact would be less than the impact described here because it would likely apply to a smaller set of services and would be limited just to Chicago, as opposed to the entire state. However, because the tax is likely to be so narrowly conceived, it may be even easier for affected businesses to avoid. Unlike a state-level tax, which a firm would need to relocate a significant distance to avoid, a city-level tax could be avoided simply by relocating to the suburbs of Chicago.

<sup>1</sup> Alex Brill, *Economic Impact of Taxing Professional Services in Illinois*, May 2016.

# Conclusion

A targeted, Chicago-only tax on law firms, accounting firms, and other professional service providers will cause these firms to take steps to avoid the tax, and this will not be good for the city's economy. Ultimately, the tax can be expected to drive professional service firms away from Chicago, leading to reduced output and income, as well as job losses spanning multiple industries. In short, the tax idea that Mayor Lightfoot has been touting would be one of the worst ways to seek new revenue for the city.

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## ABOUT THE AUTHOR

Alex Brill is the CEO of Matrix Global Advisors, an economic policy consulting firm. He is also a resident fellow at the American Enterprise Institute and in 2010 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.

