

**Written Summary of Corporate Income Tax Expenditure
Testimony to the Joint House and Senate Revenue Committee
Tuesday, July 19, 2011, and Tuesday, August 2, 2011**

1. Background for Analysis.

- This Committee is embarking on an analysis of what should be appropriate corporate tax policy for Illinois. To get that inquiry right, the process must be informed by best practices and accurate data. No pre-conceived conclusions should bias the inquiry.
- From a best practices standpoint, there are six basic principles of sound tax policy—i.e. it should be:
 - (i) fair to taxpayers;
 - (ii) responsive to the economy;
 - (iii) stable during poor economic cycles;
 - (iv) efficient so that it does not distort private markets;
 - (v) transparent to enhance taxpayer compliance and governmental accountability and
 - (vi) predictable so taxpayers can reasonably project their liability.
- Moreover, taxes should be levied at the lowest rates on the broadest base possible, giving consideration to each of the preceding principles.
- One of the key inquiries of this Committee is culling evidence about the efficacy of offering tax breaks to private sector businesses. Each such tax break carves out a slice of the state's income tax base for the benefit of a defined group of taxpayers over similarly situated taxpayers that do not qualify.
- Tax breaks offered to businesses are appropriately called "Tax Expenditures"—because in effect government is spending public taxpayer money indirectly through the tax code to produce a public good or service.
- In the case of a direct expenditure, government collects tax revenue from taxpayers and then spends that revenue to pay for delivery of a public service. In Illinois, over \$9 out of every \$10 of General Fund spending historically goes to the four, core service areas of: (i) Education (35%); (ii) Healthcare (30%); (iii) Human Services (21%); and (iv) Public Safety (6%).
- In the case of a corporate tax expenditure, government allows a private sector taxpayer to retain tax revenue which that corporation otherwise would have had to pay, in exchange for that taxpayer funding delivery of a public good.
- The public good that private businesses are to fund in exchange for receiving a tax expenditure is most commonly economic development in the form of job creation.
- Hence, evaluating the efficacy of tax expenditures requires you to apply the aforesaid best practices to actual data organized generally around the following two-part inquiry:

- (i) first, will tax expenditures generally or a given tax expenditure specifically, considering the totality of the economy and the state's existing corporate tax policy, be likely to produce the desired public good—i.e. job creation; and
- (ii) second, if it is likely, is providing said tax expenditure (A) the most effective way to generate the desired public good of job creation and (B) the most effective utilization of public taxpayer revenue—compared to say, cancelling a given tax expenditure, collecting what would have been foregone tax revenue and spending it on the provision of direct services?

2. Assessing whether it can be reasonably expected that tax expenditures given to private businesses will produce job creation, given the totality of the economy and existing Illinois corporate income tax policy.

a. Current Economic Data

- According to the Bureau of Economic Analysis (BEA):
 - (i) since the “Great Recession” ended in June 2009, corporate profits are up by approximately \$700 billion in nominal, non-inflation adjusted dollars, which is an increase of almost 50 percent over that period;
 - (ii) this compares favorably to the increase realized in corporate profits for the two-year period following the end of the last two most recent recessions of 11 percent for the 1991 recession and 28 percent for the 2001 recession.
- Out of concern that the percentage increase in corporate profits may be artificially inflated due to the severity of the Great Recession, CTBA obtained the BEA data showing the percentage increase in corporate profits from November 2009—one month before the Great Recession began—through two years after the Great Recession ended, and found that corporate profits had increased by 22 percent over this period.
- It therefore appears corporate profitability has recovered quite well since the end of the Great Recession—but what does that mean in context of the national economy generally and job creation specifically?
- This requires an analysis of how much of the growth in national income (using solely BEA and Bureau of Labor Statistics (BLS) datasets) is attributable to corporate profits versus growth in wages and salaries.
- Northeastern University analyzed the aforesaid BEA and BLS datasets from the trough (that is deepest/worst point) of the Great Recession, which was the second quarter of 2009, through the end of the first quarter of 2011—on an inflation-adjusted basis (using the Consumer Price Index or “CPI”) measured in 2010 dollars.
- According to that inflation-adjusted BEA and BLS data from the deepest point of the Great Recession through March 31, 2011:
 - (i) total national income increased by \$505 billion;
 - (ii) during the same time, corporate profits increased by \$465 billion—accounting for 92 percent of all national income growth; and
 - (iii) wages and salaries were DOWN by \$22 billion.
- From the trough of the Great Recession (2nd quarter of 2009) through the first quarter of 2011:
 - (i) corporate profits are up 49.6%, the Dow Jones is up 45.8% and the S&P 500 is up 44.3%; while

(ii) median weekly earnings of full-time employees are down 1.0% and total civilian employment is down 0.5%.

- To summarize, from the lowest point of the Great Recession through the end of March 2011, corporate profits have increased significantly, accounting for 92 percent of all national income growth, but that has not lead to job creation, with total civilian employment 0.5% less on March 31, 2011, than at the worst point of the Great Recession.

b. The Impact of State Corporate Income Tax Policy

- Much has been made of the January, 2011, increase in the Illinois corporate income tax rate from 4.8% to 7% (until 2015, when said rate declines to 5.25%). However, as Figure 1 shows, Illinois’ new corporate income tax rate of 7% is still lower than Indiana (8.5%) and Wisconsin (7.9%) in the Midwest, and most states of similar size nationally.

Figure 1

Illinois: 7% until 2015, then 5.25%	
<u>Midwest</u>	<u>Other Big States</u>
Iowa: 6% – 12% (12% @ \$250,000)	Pennsylvania: 9.99%
Indiana: 8.5%	New Jersey: 9%
Wisconsin: 7.9%	California: 8.84%
Missouri: 6.25%	New York: 7.1%
Kentucky: 4% - 6% (6% @ \$100,000)	Florida: 5.5%
Michigan: 4.9%	

- True, Illinois local governments assess a Personal Property Replacement Tax corporations have to pay, that is assessed against 2.5% of corporate taxable income for C-corporations, and 1.5% for other businesses (i.e. S-corporations, limited liability companies and partnerships). The Personal Property Replacement Tax was established by Public Act 81SS1-1, during the special session of the 81st Illinois General Assembly.
- As the name implies, this income-based tax replaces the old personal property tax assessed against certain corporate equipment and inventory. Forty-one states still have a personal property tax, including Indiana, Michigan, Iowa, Missouri, Kentucky, Wisconsin and New Jersey. So it would be “an apples to oranges” comparison to lump the Illinois Personal Property Replacement Tax in with the state income tax for comparison to other states, without accounting for the impact of their respective corporate personal property taxes.
- Moreover, Illinois’ decision to replace the personal property tax with a tax based on income works to the benefit of businesses. After all, a personal property tax must be paid irrespective of corporate profitability, whereas an income-based tax is only payable once a business is profitable.
- But, given all the concern expressed over the state’s corporate income tax rate, CTBA analyzed the Annual Survey of State Government Tax Collections published by the U.S. Census Bureau and compared those total tax collections to the Net Income reported by corporations to the Internal Revenue Service (IRS).

This allowed CTBA to calculate the actual, effective, aggregate state income tax rate paid by corporations nationally. CTBA ran the data for the 10-year period preceding the Great Recession, to avoid understating business tax burden due to profit loss during the Great Recession. As Figure 2 shows, the total effective state income tax rate by corporations is quite low, ranging from 2.85% in 1998 to 2.35% in 2007.

Figure 2
National Effective State Income Tax Burden for
Corporations (inclusive of all state corporate income taxes)
 (all \$ amounts are nominal and expressed in millions)

	1998	2003	2007
Total state corporate income taxes paid nationwide*	\$31,089	\$28,384	\$52,915
Net Income (before payment of income taxes) of corporations nationwide	\$1,091,150	\$1,175,609	\$2,252,874
Effective Total State Income Tax Rate	2.85%	2.41%	2.35%

*Annual Survey of State Government Tax Collections—U.S. Census Bureau

**SOI Tax Stats—Returns of Active Corporations – Table 1 – IRS

***Simple math—line 1 divided by line 2

- In 2007, the total state corporate income tax revenue collected in Illinois was \$2.517 billion. Hence, if in 2007 Illinois collected zero in state corporate income taxes, the effective national state income tax rate would decline by just 0.12 percent, from 2.35 percent to 2.23 percent.

c. Conclusion

- Given:
 - (i) the significant increase in corporate profitability since the Great Recession coupled with a national decline in total civilian employment over the same period;
 - (ii) the relatively low aggregate cost imposed on businesses by state corporate income taxes nationally; and
 - (iii) the very small portion of those state corporate income tax costs imposed by Illinois, there can be no reasonable expectation that state tax expenditures—which allow businesses to retain more of their profits—will result in job creation, since significant corporate profitability currently exists and job creation has not followed.
- Although no immediate job creation activity can be expected from granting or maintaining corporate tax expenditures, the evaluation your Committee is undertaking is focused on getting long-term policy correct. And there is some credible evidence that tax expenditures do, in certain circumstances, incentivize the desired activity. Hence, to make sound, long-term decisions, you must cull the evidence necessary to answer the second series of questions about the efficacy of tax expenditures.

3. Assessing whether tax expenditures are either (a) the most effective way to generate the desired public good of job creation; or (b) the most efficient, best utilization of public taxpayer revenue, compared to collecting revenue that would have been forgone and spending it on one of the four, core service areas of education, healthcare, human services and public safety.

- (a) **Are tax expenditures the most effective way to generate the desired public good of job creation?**

- This threshold question was best answered by Mark Zandi, a PhD economist who is the principal economist at Moody’s.com and served as the lead economic advisor to Republican Senator John McCain of Arizona during McCain’s presidential run in 2008.
- Zandi developed a simple metric for determining how certain tax breaks and/or public expenditures create an economic multiplier as they move through a state’s economy, using actual historic datasets.
- An economic multiplier, defined by economics textbooks such as Dornbusch and Fischer’s *Macroeconomics*, is “the amount by which output changes when autonomous aggregate demand increases by one unit.” OK, what does that mean? The definition may sound arcane, but what happens is very straightforward. Say state government invests in a new road or in bridge construction. State government initially stimulates the economy by making a direct payment to contractors, construction workers, etc. for work and economic activity that otherwise would not take place. As these individuals then spend some of the money they earn from the state on other purchases in the economy, such as food, clothing or car repairs, a portion of the initial state investment made on construction becomes additional purchases in other sectors. One person’s spending becomes another individual’s income, who in turn spends that income again on other purchases in the local economy, and so on.
- Zandi modeled how this multiplier effect works for different types of fiscal practices (spending increases and tax cuts), as detailed in Figure 3.

Figure 3

Government Action	
Tax Cuts	Associated Multiplier
Non-Refundable lump-sum tax rebate	1.02
Refundable lump-sum tax rebate	1.26
Temporary Tax Cuts	
Payroll Tax Holiday	1.29
Across the board tax cut	1.03
Accelerated Depreciation	0.27
Permanent Tax Cuts	
Extend alternative minimum tax patch	0.48
Make Bush income tax cuts permanent	0.29
Make dividend/cap gains tax cuts permanent	0.37
Cut in corporate tax rate	0.30
Spending Increases	
Extending Unemployment Insurance Benefits	1.64
Temporary increase in food stamps	1.73
General aid to state governments (for spending on items such as education, public safety, health and human services)	1.36
Increased infrastructure spending	1.59

- As Figure 3 illustrates, the largest economic ‘bang for the buck’ comes from spending increases, not tax cuts.
- Nonetheless, in some instances tax expenditures are not designed to stimulate immediate job creation. Other legitimate purposes for tax expenditures include items such as encouraging research for long-term

economic development and getting the tax base correct. Obviously, getting the tax base right—that is only taxing those corporate profits that may rationally be apportioned to Illinois—is a fundamental aspect of tax policy and beyond the scope of this testimony. Hence, tax expenditures to incentivize other desired corporate activity must still be scrutinized.

b. Is a given tax expenditure the most efficient/best use of public taxpayer revenue, or would it be better to collect what would have been forgone in revenue and spend it on provision of direct services?

- Making this determination involves a number of specific inquiries, which include:

(i) What is the counter-factual—that is, would all or a portion of the desired job creation (or other incentivized behavior) occur without the tax expenditure? Are there reliable studies/datasets available to determine the effectiveness of the tax expenditure, or are there too many methodological flaws/differences to make the findings relevant?

(ii) What is the fiscal impact? Although stimulating job growth does in fact generate revenue, in many cases the cost of the expenditure exceeds the new revenue generated from job creation.

(iii) Is the tax expenditure fair to other, similarly situated businesses that do not qualify for the credit? This is an important inquiry, given that, according to the Illinois Department of Revenue, only 0.7% of all c-corporations that filed Illinois corporate tax returns claimed the full \$161 million in business development tax credits made available by Illinois in 2008.

(iv) What is the cost per job created and is it justifiable?

(v) Are the tax expenditures transparent and does the state monitor their performance?

(vi) Finally, would the state have simply been better off collecting what would have been the forgone revenue and spending it on current services like education, healthcare, human services and public safety? This involves both normative and empirical analyses.

- At this time, CTBA has no formal recommendations as to the state's corporate income tax rate nor the type and scope of business tax expenditures made available. Certainly, some tax expenditures could be positive in generating jobs and encouraging activity such as research that is in the state's long-term economic interest. That said, given the state's fiscal woes and the reality of the current economy, a thorough evaluation of corporate tax expenditures is required to ensure only those that do, or can reasonably be expected to, serve the public interest be maintained.

Respectfully submitted,

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