The Illinois Economy: Taxing Business

Do corporate taxes (and tax incentives) help or hurt the Illinois economy?

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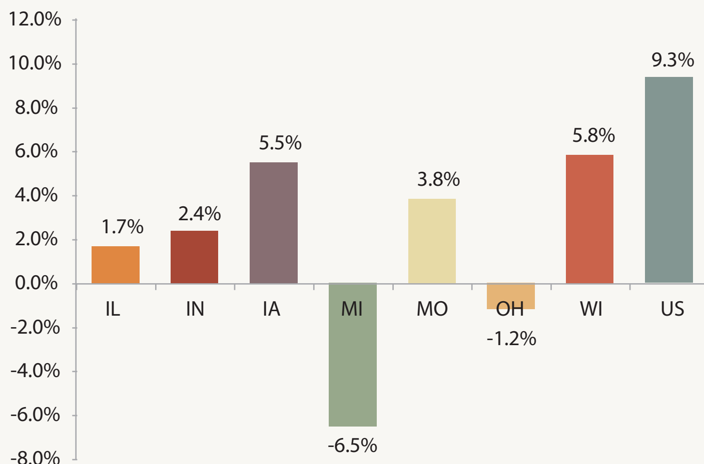
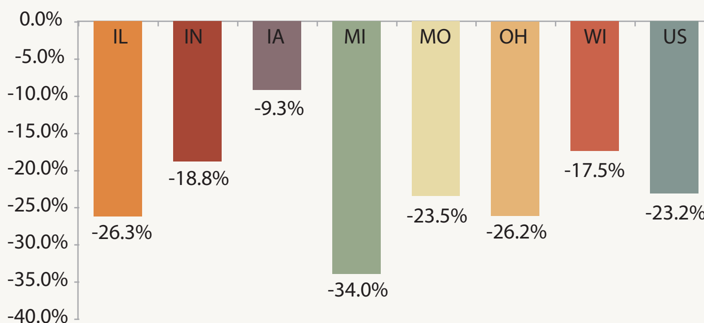
By Nathan B. Anderson and Joshua J. Miller

Attracting and retaining businesses is crucial to Illinois' economic performance. Illinois' efforts to attract and retain businesses include policies and programs that reduce the tax liability of Illinois' businesses. In the last 10 years, however, the number of jobs in Illinois has increased by only 1.7 percent, compared to a 9.3 percent increase in employment in the United States. The rather slow pace of employment growth combined with the increasing mobility of businesses between states causes many to argue that, in order to attract and retain business, Illinois must lower its business taxes.[1]

In this chapter, we examine business taxation in Illinois using the criteria of equity, efficiency, and simplicity. The equity of a tax system is measured by the relationship between the ultimate distribution of the tax burden and societal notions of fairness. For example, should two businesses with the same profits pay the same amount in business taxes? The efficiency of a tax system can be evaluated in terms of economic growth. If changes to the current system could increase employment growth while leaving revenues at the same level, we could call the current system inefficient. The simplicity of a tax system is measured by the costs of taxpayer compliance and system administration. A simpler and less administratively costly business tax system is desirable because it collects revenue at a lower cost to taxpayers.





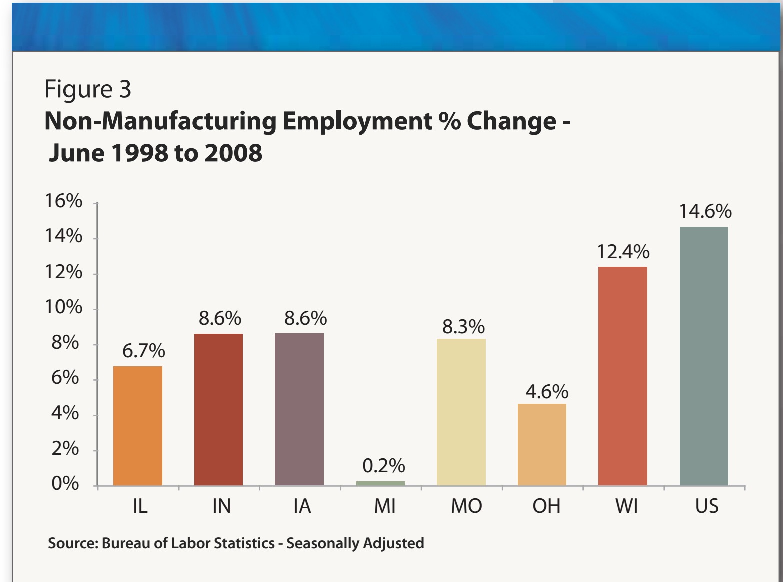
Economic Performance

An inefficient tax system could manifest itself in the form of high tax rates that discourage businesses from locating in Illinois. The low level of employment growth in Illinois can cause concern about the level of business taxes. Yet the loss of manufacturing jobs in Illinois, not high tax rates, explains much of the low level of employment growth. Illinois lost more than 26 percent of its manufacturing jobs in the last 10 years. During the same period, the United States lost more than 23 percent of its manufacturing jobs and nearly all of Illinois' neighbors experienced double-digit declines as well. Illinois' non-manufacturing employment, however, has increased

[1] Phil Gramm and Mike Solon. *Wall Street Journal*, September 13, 2008.

in the last 10 years by nearly 7 percent, a smaller percentage increase than every neighbor except Michigan (0.2 percent) and Ohio (4.6 percent).

Most of the employment increases in Illinois come from the service sector. Professional and business services, education and health services, and leisure and hospitality services experienced the largest increases in employment from 1998 to 2008. Illinois neighbors, or the Rest of the Midwest (RMW), exhibit similar employment trends, although the employment declines in RMW tend to be smaller and the employment increases tend to be larger than those in Illinois.



Although many sectors do not display employment increases, nearly every sector of the Illinois economy exhibits increases in Gross State Product (GSP). The GSP for a sector is the value of all goods and services in that sector produced within Illinois. Some sectors, like Information, display employment declines alongside increases in GSP, indicating an increase in workers' productivity. That is, it takes fewer workers to produce goods and services of higher value. Again, however, Illinois' GSP gains are smaller than those of the nation and its neighbors. Thus even after considering the regional losses in manufacturing employment, Illinois still exhibits relatively low levels of economic growth compared to its neighbors.

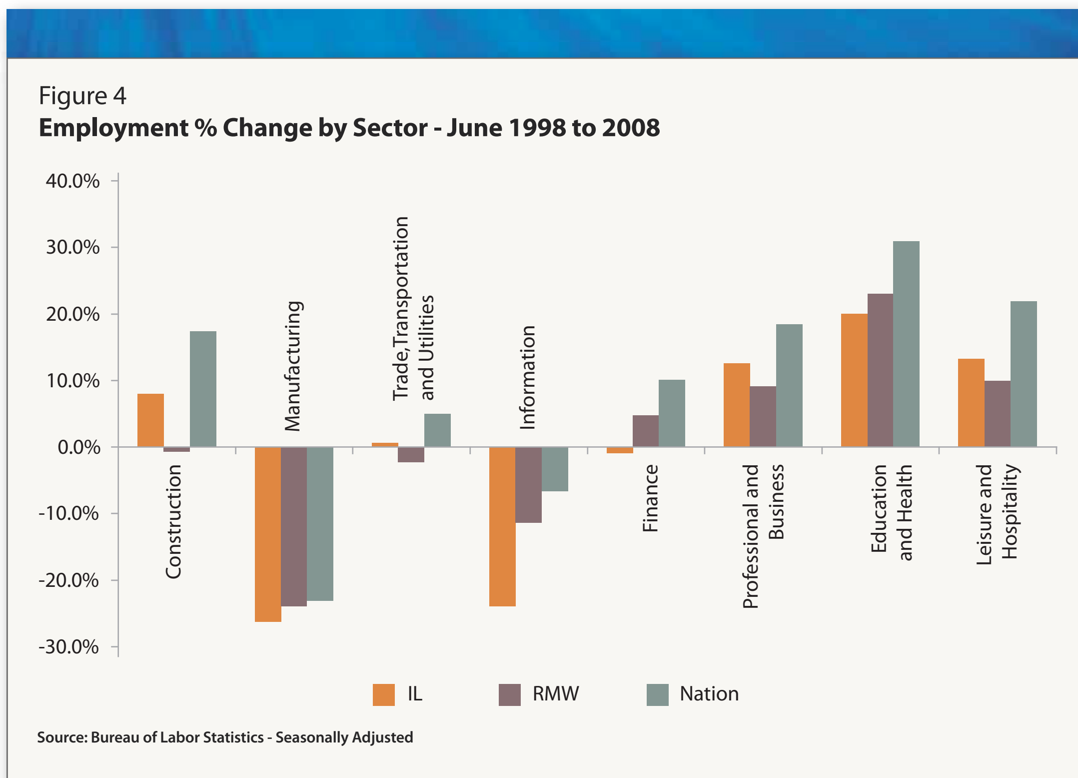
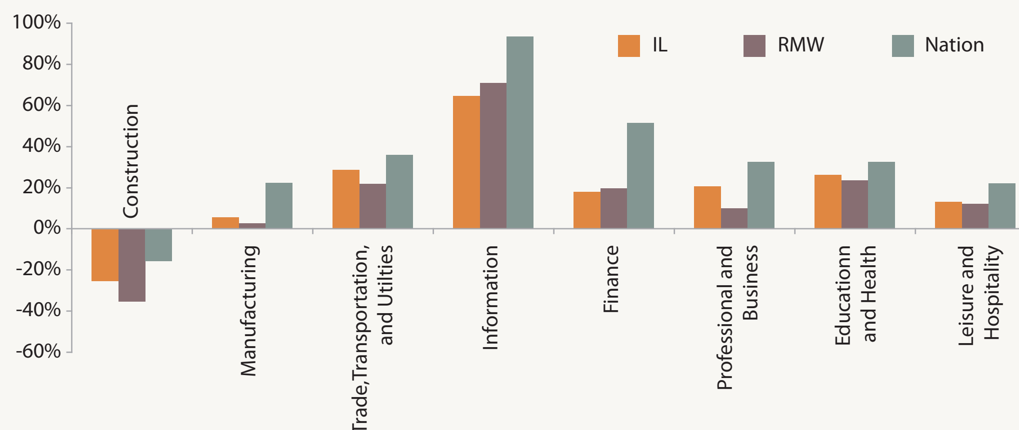


Figure 5
GSP % Change by Sector 1998 to 2007



Source: Bureau of Economic Analysis - Real GDP by State (Millions of chained 2000 dollars)

Illinois' Business Taxes

Tax Rates and Tax Base

Although businesses in Illinois pay property taxes and sales taxes, the taxes directly targeted at business are the corporate income tax and the personal property replacement tax. Illinois' flat rate makes its corporate tax system relatively simple. The Illinois corporate income tax was enacted in 1969 at a rate of 4 percent and since 1989 has been set at 4.8 percent. Subtracting deductible expenses from revenue produces taxable corporate income as defined in Illinois; this definition is almost identical to the federal definition. Employees' wages, materials and services purchased from other firms, interest expenses, and depreciation of capital are considered deductible expenses; investments in plant and equipment, however, are not deductible expenses. Thus, corporate tax revenue at both the federal and state level comes at the expense of reducing the incentive for corporations to invest in plant and equipment.

Other types of business: S corporations, partnerships, and limited liability corporations are not subject to the Illinois corporate income tax. Illinois taxes S corporation, partnership, and limited liability corporation income at the individual income tax rate of 3 percent. The trend in recent years has been for companies to incorporate under Chapter S of the Internal Revenue Service code due to both federal and state tax benefits. S corporations became the most common type of corporate entity in 1997. (See Table 1.)

All C corporations, S corporations, limited liability corporations, and partnerships must pay the Illinois Personal Property Replacement Tax (PPRT). The PPRT is an income tax with a rate of 2.5 percent for C corporations and 1.5 percent for S corporations, limited liability corporations, and partnerships. That is, the PPRT is an add-on to the corporate income tax rate for C corporations and a separate corporate tax for S corporations, partnerships, and limited liability corporations. Illinois taxes C corporation business income at an effective rate of 7.3 percent and all other business income at an effective rate of 4.5 percent.

Apportionment of Corporate Income

Complicating any state corporate tax system is the need to apportion corporate income across different states. Many companies located in Illinois and subject to the corporate income tax have operations

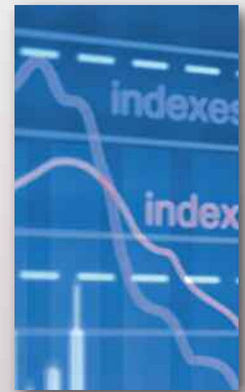


Table 1
Business Structure Defined

	IL Effective Tax Rate
C-Corporation: Large to mid-size companies owned by many shareholders. Income is taxed at receipt by the corporate income tax and also upon distribution via individual income tax returns.	7.3%
S-Corporation: Companies with 100 or fewer shareholders. Income is taxed once via individual income tax returns.	4.5%
Limited Liability Corporations (LLC): The LLC provides owners shelter from certain liability and is most suitable for single owner companies. Income is taxed once via individual tax returns.	4.5%
Partnership: Companies with two or more members in which profits and losses are divided equally among partners. Income is taxed once via individual income tax returns.	4.5%

and sales in other states. Therefore it is necessary to determine what portion of a company's total U.S. taxable income is taxable in Illinois. Individual state governments have some discretion in determining exactly what share of a corporation's total U.S. income is apportioned to their state. Currently, Illinois' share of a company's total U.S. taxable income equals the share of the company's total sales that occur within Illinois. A corporation with $10 million of total U.S. income and 30 percent of its sales within Illinois owes Illinois corporate income taxes on apportioned income of $3 million.

Although this same hypothetical corporation may also have, for example, 40 percent of its property and 30 percent of its payroll in Illinois, this will not affect its Illinois apportioned income. Before 2001, however, Illinois required a corporation to apportion half of its income on the basis of sales location, one-quarter on the basis of property, and one-quarter on the basis of payroll. The corporation with $10 million in U.S. income would then owe taxes on apportioned income of $4 million.

The 2001 switch to 100 percent sales apportionment, or single sales factor (SSF), was designed to attract and retain manufacturing firms. Under SSF, corporations making additional investments in property and increases in payroll do not incur increases in Illinois corporate tax payments. The switch to SSF, however, did not reduce total corporate tax liability for all corporations with property and payroll in Illinois. Any corporation with more of its sales in Illinois than property or payroll experienced an increase in corporate tax liability. For example, a corporation with 80 percent of its property and 80 percent of its payroll within Illinois, but 90 percent of its sales within Illinois would see its corporate tax liability increase rather than decrease. At the other extreme, a corporation with 100 percent of its payroll and property but none of its sales within Illinois would pay no corporate income tax. Although SSF can have some complicated effects on corporate tax liabilities, apportionment based only on sales makes the corporate tax system simpler.

Tax Reductions for Business

Illinois offers reductions in tax liability to businesses engaging in specific types of activities in certain locations. Although these tax reductions can encourage business location and increase employment, they add to the complexity of the corporate tax system.

As with the switch to SSF, these tax-relief programs are mainly geared toward the attraction and retention of manufacturing firms. In fiscal year 2007, the two tax-relief programs responsible for the largest tax reductions, the Research and Development (RD) tax credit and the Economic Development for a Growing Economy (EDGE) tax credit, saved C corporations $35.8 million and $24.8 million in corporate tax payments.[2] The reported magnitude of these

[2] Source: Illinois State Comptroller—Tax Expenditure Report 2007.

tax reductions varies substantially over time. As recently as 2004, corporate tax savings due to the RD and EDGE tax credits were $8.1 million and $5.2 million.

The RD credit allows businesses to reduce tax liability when they increase expenditures on research and development activities conducted in Illinois. The reduction in tax liability is equal to 6.5 percent of the increase in R&D expenditures over the average level for the previous three years. As an example, imagine a business spends an average of $100,000 per year from 2004 to 2006 on R&D activities within the state. During 2007, the business increases R&D expenditures to $150,000. The difference between the current year R&D expenditures of $150,000 and the 3-year average of $100,000 represents a $50,000 increase in R&D expenditures. The business is therefore allowed to claim 6.5 percent of that $50,000 or $3,250 on the 2007 tax return as a business credit. This business credit would reduce the business's 2007 tax bill by $3,250.

The Illinois Department of Commerce and Economic Opportunity (DCEO) awards the EDGE tax reductions to businesses on a case-by-case basis. According to DCEO, companies actively considering moving away from the state or establishing a satellite location outside of Illinois are eligible for the EDGE tax reduction. Companies relocating within Illinois, however, may also receive it. Since EDGE's inception, Illinois has approved more than 400 of 530 applications.[3] Figures from the Illinois Office of the Comptroller indicate that the tax reductions awarded to corporations through the EDGE program have almost quadrupled since 2004.

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Although the amount of the tax credit is negotiable, the maximum credit is the amount of income taxes paid by the company's newly hired or retained employees. Yet, DCEO also notes that a company may qualify for additional EDGE benefits under the Business Location and Efficiency Act. Companies receiving the EDGE credit may elect to use the credit in any of the subsequent five years. The program appears to focus on the manufacturing sector as eligibility requires substantial capital investments in Illinois and retail businesses are not eligible. The private nature of the EDGE application process makes it difficult to determine its effectiveness at attracting and retaining businesses. It is possible the EDGE program reduces taxes for firms that would have remained in or located in Illinois regardless of their tax liability. Specific information about the recipients of the credit, their applications, and the size of each tax reduction is not publicly available. On occasion, however, the governor's office releases general information on individual firms' DCEO awards.

Illinois offers many other programs that reduce the tax liability of businesses and add complexity to business taxation. The Foreign Insurers Rate Reduction tax credit reduces corporate taxes for many out of state insurance providers. Enterprise zones offer tax reductions for businesses that locate in economically depressed areas, while the High Economic Impact Business Tax Credit lowers taxes for businesses that make large capital investments and create hundreds of jobs. Illinois also offers the recently created Film Production Services Credit to promote film production within the state.[4]

Tax Rules that Reduce Business Taxes

Several tax rules also serve to reduce the tax liability of Illinois' businesses. There are strong efficiency arguments for maintaining these rules even though doing so reduces state tax revenue.

Illinois, along with most other states, does not impose sales taxes on a majority of business-to-business purchases. These sales tax exemptions reduce corporate tax

[3] Illinois Department of Commerce and Economic Opportunity (DCEO).

[4] See the Illinois DCEO for a complete list of tax credits, expenditures, and other business incentive programs.

payments but are an essential feature of a well designed sales tax. A well-designed sales tax system taxes final consumption and exempts business-to-business purchases from taxation. Taxing business-to-business purchases creates inefficiency by taxing the various inputs of a final consumer product.

For example, automobile makers require brake pads and seatbelts for their cars. They can produce brake pads and seatbelts themselves or purchase them from other businesses, which may be less expensive. But, to avoid paying sales taxes, the manufacturer might produce its own brake pads and seatbelts, which adds to production costs. Exempting business-to-business purchases from the sales tax allows the manufacturer to produce cars at a lower cost. The lower costs represent an increase in efficiency that may result in lower automobile prices and higher autoworker wages.

Illinois, along with the federal government and most states, also allows corporations to deduct net operating losses (NOLs) from their past and future years' corporate taxable income. Eliminating corporations' ability to carry NOLs forward and backward, restricting their use to only the current tax year, would dramatically increase corporate tax revenues. There are, however, some very persuasive arguments for retaining the NOL carry-forward and carry-back provisions. One argument is that the ability to carry forward NOLs differentially helps new firms and entrepreneurs that often lose money early on. Without NOL carry forward, these entrepreneurs could not make up for early losses by reducing future tax liability once the firm becomes profitable.

Business Taxes in Other States

Illinois' corporate tax rate and apportionment formula are very similar to those in neighboring states. By 2011, Indiana, Iowa, Michigan, Missouri and Wisconsin will have SSF apportionment of corporate income. Thus, any regional advantage gained by Illinois' switch to SSF was short lived. Michigan and Missouri are the only two neighboring states that have lower corporate income tax rates than Illinois.[5] Thus, the state tax burden placed on Illinois corporations does not seem excessive when tax rates and apportionment are compared to RMW.

Table 2
Tax Year 2008 - Midwest States

State	Apportionment	Brackets	Tax Rate
Illinois	100% Sales	Flat	7.30%
Indiana	70% Sales	Flat	8.50%
Iowa	100% Sales	4	6% - 12%
Michigan	100% Sales	Flat	4.95%
Missouri	100% Sales	Flat	6.25%
Ohio	60% Sales	2	5.1% - 8.5%
Wisconsin	100% Sales	Flat	7.90%

Notes: IN will be 100% sales by 2011. OH eliminates its corporate income tax in 2010. MO provides taxpayers the option of choosing either 3-factor formula (33% each to sales, property, payroll) or 100% sales.

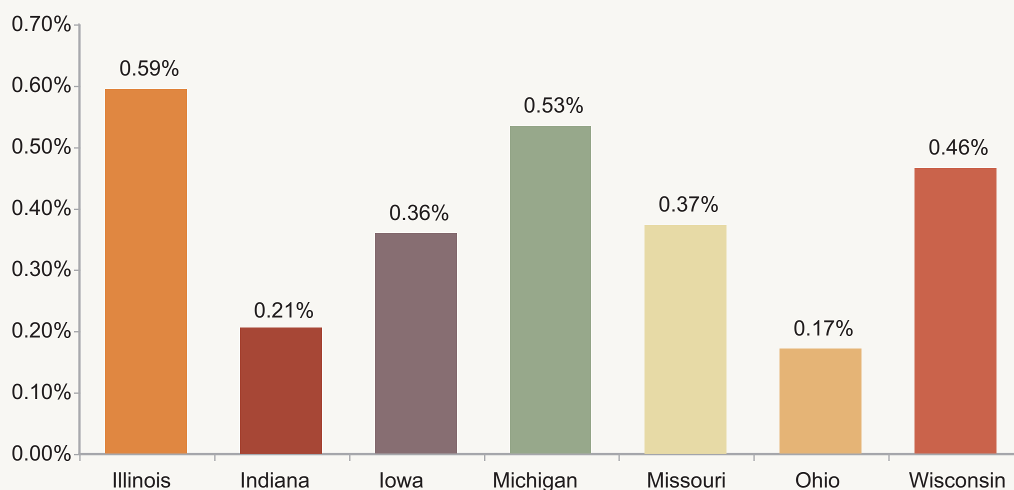
Source: Federation of Tax Administrators

Examining states' business tax collections as a share of each state's Gross State Product, however, reveals that Illinois' business tax burdens are relatively higher than those in other states. In 2007, business tax collections in Illinois represented 0.59 percent of GSP, while Wisconsin's business tax collections represented only 0.46 percent of that state's GSP. By no means is 2007 a special year, as Illinois' ratio of business tax collections to GSP is higher than all the states in RMW in all recent years.

Illinois' programs to reduce business tax liability are very similar to those in nearby states. Indiana even calls one of its prominent tax reduction programs EDGE and its details are very similar to Illinois' EDGE program. The Illinois and Indiana EDGE programs both provide tax relief in proportion to the state income tax liability of

[5] Iowa and Ohio have a progressive corporate tax system where the highest rate exceeds Illinois' flat corporate income tax rate of 7.3% for C Corporations.

Figure 6
Business Tax Collection as a % of GSP in 2007



Source: Bureau of Economic Analysis—Real GDP by State (Millions of chained 2000 dollars) and state government sources.

newly-hired or retained employees. Indiana's program, however, appears to require less capital investment by firms and does not explicitly deny the credit to retail businesses, possibly making it available to more non-manufacturing firms.

Ohio also offers similar programs under different names. The Job Creation Tax Credit and the Job Retention Tax Credit offer relief based on income tax payments of newly-hired or retained employees. As is the case in Indiana and Illinois, a small group of board members makes the final decisions on amounts of the credit and recipients of the credit. And, as also is the case in Illinois, information on the amounts of the credit and recipients of the credit do not appear to be publicly available.

Nearly all of Illinois' other tax reduction programs appear in different guises across the Midwest. Wisconsin offers a research expense credit, enterprise zone job credit, and film production credit. Michigan has a R&D tax credit, Renaissance Zone tax credit, and film production tax credit. Although there are minor differences in the rates or amounts, the basic structure and intent of each credit is strikingly similar to those available in Illinois.

What Can Illinois Do?

No state has a corner on the market for tax incentives. Even if Illinois had a peculiar ability to design very effective incentives, its neighbors surely would copy them, thereby erasing any advantage. Thus even when tax incentive programs are successful, any gains they produce will likely be temporary. When all nearby states offer similar programs, however, it's difficult to argue that Illinois should remove its business tax incentives. Illinois should focus on increasing the transparency and simplicity of business taxation and possibly consider broadening the scope of its business tax relief efforts.

Because tax incentive programs come with costs and benefits, it's important that information about these programs be publicly available. The Illinois comptroller's tax expenditure report represents an important, if imperfect, example of efforts to increase the transparency of the tax system. Although the tax expenditure report provides an estimate of the EDGE program's

cost in terms of tax revenues, there is no easily accessible report about the recipients of the EDGE credits. To an observer, the application process may appear complex, mysterious, and capricious simply due to the lack of public information. Without more information, it's difficult for policy-makers and the public to understand these complex tax incentive programs, let alone reform them.

Illinois tax credits focus mainly on manufacturing firms while neighboring Wisconsin has several tax credits that focus more on the technology driven industries. Examples include the Broadband Internet Equipment Exemption and Credit and the Technology Zone Credit. If similar credits exist in Illinois, they are not well advertised.

Recently, Michigan has made significant changes to its entire tax structure, including the introduction of 11 new business tax credits and the retention or expansion of 15 more. This new system retains a focus on manufacturing but also includes benefits for small business owners and a completely separate taxing rate for the insurance and financial industry. While keeping in mind the transient nature of these benefits, Illinois possibly could gain by focusing tax credits more on non-manufacturing firms.

Rather than offering tax reductions only in certain sectors of the economy, Illinois could reduce its corporate income tax rate. Lowering this rate might attract new firms and increase employment but it also will lower taxes for existing firms that would have remained in Illinois even without the reduction. Suppose Illinois could create 1,000 new jobs but these new jobs would reduce state tax revenues by $100 million per year. Are 1,000 new jobs worth $100,000 per job per year? The answer clearly depends on the quality of those new jobs, tax revenues gained from the new employees, the potential reductions in state programs because of lower tax revenues, and other factors. Counting jobs without accounting for the cost of that job creation can lead to higher costs for Illinois taxpayers.

The move to SSF apportionment may have helped Illinois retain manufacturing jobs, but it is difficult to ascertain the effects of SSF when manufacturing employment is in such a steep decline. It is possible that the decline in manufacturing employment could have been more dramatic without the 2001 move to SSF. Again, all of Illinois' neighbors will use SSF by 2011, so Illinois will lose its advantage before long.

Public concern about fairness and equity can often be as strong as concern about the economy. For example, under SSF an Illinois corporation with large profits will pay no income taxes if it makes all of its sales to consumers in other states. Thus, although SSF can encourage companies to increase employment in Illinois, it also can cause some high-profit corporations to not pay any state corporate income taxes. When some businesses pay no taxes, other businesses and taxpayers might question the fairness of the tax system.

Targeting a tax at some disembodied sector of the economy named business will ultimately be unsuccessful. People pay taxes and ultimately some person, not some legal entity, will bear the economic burden of the corporate income tax. The burden might come in the form of lower wages, higher prices, or lower after-tax profits for owners of firms. It is not known for certain which persons will bear the burden of the tax.

If a business cannot really *pay* a tax, then why does Illinois have a corporate income tax? One prominent argument for a corporate income tax is that corporations have a high ability to pay so they should pay more taxes than, say, a middle class family. This argument addresses the equity of the

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tax system and assumes that it is relatively wealthy business owners, not workers and consumers, bearing the economic burden of the corporate income tax.

Arguments for reductions in business taxes similarly assume that it is the owners who bear the burden of the tax in the form of lower profits. If only we reduced taxes here while they remained high over there, the owners of capital, in their effort to maximize profits, would locate here and not there. Locating business capital here rather than there provides jobs here rather than there, or so this efficiency argument goes.

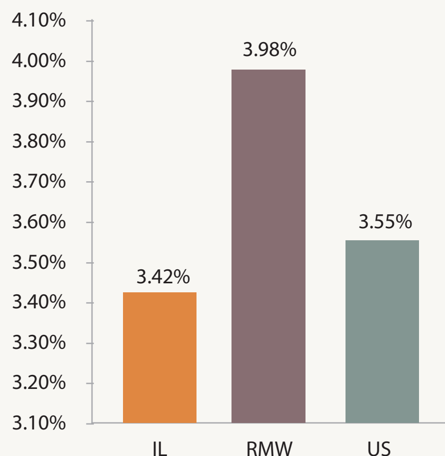
The implementation of a progressive individual tax and the elimination of the corporate income tax better serve both of the above arguments. A progressive income tax directly ensures that persons of higher means will pay more in taxes. Furthermore, Illinois already taxes the income from most corporations under the individual income tax code. Taxing individual income rather than business income would also encourage business investment to occur where it is most productive rather than where taxes are lower.

Of course, differences in taxation are not the only factors across states affecting business location decisions. Many companies prefer locations with a large supply of educated and skilled workers available for the foreseeable future. Also, Illinois' education system acts as a signal to companies as to the current and potential skill level of the work force. Since 2003, however, Illinois has trailed the RMW and the U.S. in the annual growth rate of educational expenditures. Illinois' per-pupil total spending is also consistently below levels in the RMW, with Illinois' relative shortcoming increasing in the most recent years.

Conclusion

As long as the corporate income tax exists, states will likely compete against each

Figure 7
Education Expenditure as Share of GSP 3-Year Average 2005-2003



Source: Bureau of Economic Analysis - Real GDP by State (Millions of chained 2000 dollars)
Source: U.S. Department of Education - National Center for Educational Statistics - Common Core of Data

other by lowering rates and increasing incentives. Once business taxes are lower everywhere, taxpayers in all states are left with less tax revenue to pay for public services.

Furthermore, the increasing array of incentives reduces the simplicity of the business tax system. Rather than simply facing lower tax rates in Illinois, a business is forced to navigate through a variety of tax credits, and it costs the state money to keep track of applications and the credits across years. If Illinois keeps its various incentive programs, which seems likely, it is important to address concerns of simplicity, transparency, and fairness in their execution.

Rather than engaging in a tax reduction competition with other states, Illinois could instead more fully focus its attention on enhancing its reputation as a productive location for investment. Increasing investments in education and infrastructure will make Illinois more attractive for business, but will require permanent sources of

additional state revenue. Although it may be controversial, there are strong equity, efficiency, and simplicity arguments for eliminating the corporate income tax and replacing it with a progressive individual income tax. A progressive income tax more directly taxes those with a high ability to pay taxes. Eliminating the corporate income tax and all of its special provisions and tax credits reduces the complexity of the Illinois tax system for businesses and reduces the government's administrative costs.

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