The Illinois Budget Policy TOOLBOX

Tools to Address Revenue

Business Taxes

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Business taxes are often a point of debate in discussions about raising state revenue. Economists have not come to a consensus on an ideal business tax strategy. Illinois uses the business tax similarly to most other states. However, some states have considered eliminating or replacing the corporate income tax, or adding new business taxes. Long-term effects of these policy changes are difficult to predict. This paper will provide an overview of how economists think about the business tax, and options for changes in Illinois.

What is a business tax and who pays it?

Businesses may "remit" taxes—i.e. write a check to the government for the tax due—but ultimately some person or persons must bear the burden of the tax. This burden is most likely to be on the firm's owner(s), its customers, its suppliers, or its employees. Often the burden will be shared among these groups. Thus, a tax on business is ultimately a tax on individuals.

Scholars have not reached consensus on appropriate business taxation.[1] Like other taxes, business taxes have implications for administrative efficiency, vertical equity ("fairness"), economic efficiency, and revenue stability.

Administrative efficiency. Only recently have economists thought carefully about the administrative efficiency implications of business taxes. While this research is at a relatively early stage, a growing recognition is emerging that the administrative efficiency of taxing business entities, rather than individuals, provides a powerful argument for business taxation.[2]

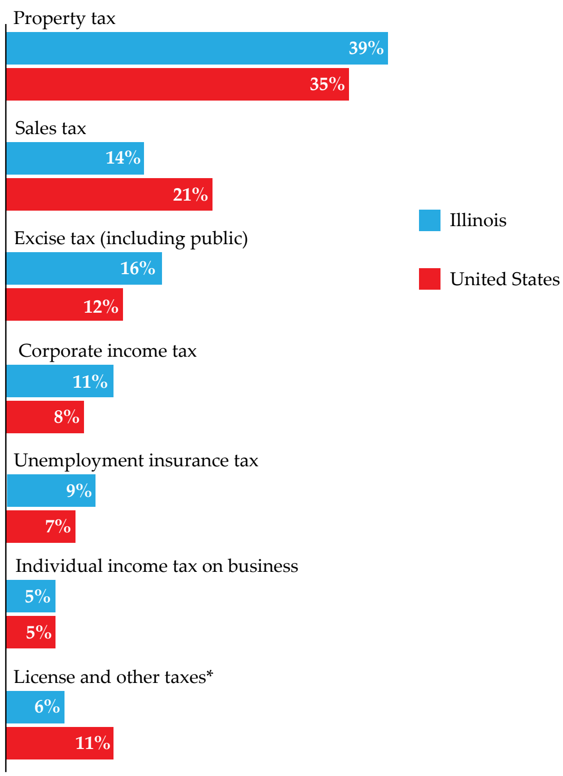
Vertical equity. It has also been difficult to produce convincing evidence on the vertical equity of various business taxes because their burden is transmitted from the business that remits the tax to the (potentially many) final bearers of the burden through various channels including changes in prices, wages and distributions of profit.

Economic efficiency. A substantial amount of research has been conducted about the relative economic efficiency of existing business taxes. The scholarly consensus is that a tax on a business equal to the cost of the services it receives promotes economic efficiency. If taxes are lower than this amount, businesses tend to expand to inefficient levels because some of their costs are subsidized. If taxes are higher than this level, business expansion may be discouraged even when the business produces output that benefits society more than its costs. However, the empirical literature

[1] In 1940, Paul Studenski wrote, "the amount of work done by our students of public finance toward the formulation…[of a sound theory of business taxation] has not been very formidable" (p.622). Unfortunately, the situation has not improved much since then. In 2007, Testa and Mattoon (p.838) wrote, "States continue to struggle with finding a sound conceptual basis in their approach to business taxation." Testa, William A. and Mattooon, Richard H. (December, 2007). Is there a role for gross receipts taxation? *National Tax Journal*, *60*(12): 821-840.

[2] See for example, Slemrod, Joel. (June 2008). Does it matter who writes the check to the government? The Economics of tax remittances. *National Tax Journal*, 251-275.

Figure 1: The Share of Total State and Local Business Taxes from Each Component, in Illinois and for the Whole US, FY2012



Note: Length of bars indicates the share of total state and local taxes from each source, so that sum of all bars of a particular color add to 100."Other taxes" include death and gift taxes, documentary and stock transfer taxes, severance taxes, and local gross receipts taxes.

Source: Author's calculations and Phillips, Andrew, Cline, Robert, Sallee, Caroline, Klassen, Michelle and Sufranski, Daniel. (2013). Total state and local business taxes. *Ernst and Young and Council on State Taxation. Available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797.*

suggests that state and local business taxes exceed the cost of providing services.[3]

Revenue stability. Evidence clearly suggests that revenue from one important business tax—the corporate income tax—is quite volatile and falls disproportionately in bad economic times.

The public policy debate about business taxes often focuses almost exclusively on the corporate income tax, which is not the most important business tax. The consulting firm Ernst and Young has produced high-quality estimates of the state and local taxes paid by businesses in each state for more than a decade.[4] For fiscal year 2012, nationally and in Illinois, they report that the property tax was the most important tax on business by a wide margin. As shown in Figure 1, the property tax accounted for 39 percent of all the taxes paid by businesses in Illinois. Excise taxes (16 percent) and the sales tax on business-to-business transactions (14 percent) were also important. The corporate income tax accounted for only about 11 percent of state and local business taxes paid in Illinois.

According to this study, the Illinois state government collects almost half as much revenue from the personal income tax on business income as it does from the corporate income tax. The reason is that many owners of businesses such as sole proprietorships and partnerships pay taxes on that income through their personal income tax rather than through the corporate income tax.[5]

The Ernst and Young study reports that, in Illinois, a little more than one-half of all state and local business taxes are paid to the state. The study also indicates that total state and local business taxes in Illinois were about $31 billion and accounted for about 45 percent of all taxes and fees paid to Illinois state and local governments. The business tax share in Illinois is quite similar to that of the nation as a whole.

Potential policy options in Illinois

In this section I briefly describe three general options for business tax modifications. Space and resource constraints preclude comprehensive analyses of each, but sections highlighting the most important likely effects on revenue and other objectives, including income distribution, follow each description. Note that several other papers in the Illinois Budget Policy Toolbox also describe policy options with important implications for Illinois business taxation.

[3]See for example, Phillips, Andrew, Cline, Robert, Sallee, Caroline, Klassen, Michelle and Sufranski, Daniel. (2013). *Total state and local business taxes.* Ernst and Young and Council on State Taxation. Available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797.

[4]Phillips, Andrew, Cline, Robert, Sallee, Caroline, Klassen, Michelle and Sufranski, Daniel. (2013). *Total state and local business taxes.* Ernst and Young and Council on State Taxation. Available at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797.

[5]Some scholarly evidence suggests that some businesses adopt specific legal (non-corporate) forms to minimize their tax liability. Fox, William F. and Luna, LeAnn. (November, 2005). Do limited liability companies explain declining state corporate tax revenues? *Public Finance Review, 33*(6): 690-720.

Option 1: Broaden the corporate income tax base by eliminating some tax deductions (or other modification to the tax base).[6]

Each year the Illinois comptroller prepares a report that enumerates and quantifies "tax expenditures," defined to be "any exemption, exclusion, deduction, allowance, credit, preferential tax rate, abatement, or other device that reduces the amount of tax revenue that would otherwise accrue to the state."[7] Essentially, tax expenditures are defined and valued by comparing actual tax revenue to the tax revenue that would be generated under a hypothetical alternative tax base (at the same rate).

Amending state tax law to eliminate some or all of the tax expenditures identified by the comptroller is a potential tool to raise additional state revenue. The definition of tax expenditures relies on the comptroller's interpretation of the appropriate hypothetical alternative tax base. Some external analysts and advocates use different or broader definitions of the hypothetical base when they identify potential additional revenue from relatively minor modifications of the tax base. These modifications are sometimes said to eliminate tax "loopholes."

Possible revenue effects of option 1: Illinois officially identifies about $319 million per year of tax expenditures from the corporate income tax.[8] More than two-thirds of this amount is attributable to a single tax expenditure: the Illinois net operating loss deduction. This provision allows corporations to use losses incurred during a year when they paid no taxes to reduce taxes in a year when they had a taxable profit.

In a report for Good Jobs First, an national policy resource center, Tommy Cafcas and Greg LeRoy identify several other provisions of Illinois corporate income tax that, while not strictly tax expenditures, could be altered to increase corporate income tax revenue.[9] These are: (i) decouple Illinois law from federal law to prevent accelerated depreciation of investments, which is estimated to raise an additional $1 billion in revenue over three years; (ii) a similar decoupling from federal law that allows expenses for certain production activities to be deducted from operating income, which would garner Illinois about $30 million in revenue per year ($103 million over three years); and (iii) replacing Illinois single sales factor for allocating multistate income with a three-factor rule based on the share of a multi-state corporation's payroll, property and sales that are in Illinois, which could increase annual corporate income tax revenue by $63 million or more.

Option 2: Create a new tax on business activity (such as a gross receipts tax or value added tax).

Several states (Ohio, Texas and Washington) and many other countries have broad-based business taxes in place of, or in addition to, corporate income taxes. These taxes take various forms. One variant is a gross receipts tax (GRT)—that is, a tax on the total revenue (or "sales") of businesses regardless of legal form (whether corporate or non-corporate). A value-added tax (VAT) is an alternative, but in some ways similar, tax on revenues. However, it allows the subtraction of some costs. Economists generally favor a VAT over a GRT, since a GRT could create an artificial inducement for firms to merge with their suppliers or customers.

Possible revenue effects of option 2: A 2007 proposal estimated that an Illinois gross receipts tax with relatively low tax rates could bring in $7 billion of revenue.[10] Of course, revenue of this magnitude could be used to supplement or replace all or a portion of the Illinois corporate income tax. Clearly, the 2007 proposal for a GRT could be modified in many ways and could be reformed into something similar to a VAT. With appropriate rate adjustment, a VAT could generate revenue comparable to a GRT.

Option 3: Create a statewide property surtax on business.

The vast majority of Illinois' property taxes are collected at the local level, but in principle, the Illinois

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[6]For more on the effects of making the 2011 tax increase permanent, see another paper in this toolbox series: Dye, Richard F. (February 2014). *Making the 2011 income tax increase permanent.* Illinois Budget Policy Toolbox. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/budget-toolbox-content-making-2011-income-tax-increase-permanent.

[7]Topinka, Judy Barr. (July 2013). *Tax Expenditure Report*. Comptroller, State of Illinois. Available at http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/

[8]Topinka, Judy Barr. (July 2013). *Tax Expenditure Report.* Comptroller, State of Illinois. Available at http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/

[9]Cafcas, Thomas and Leroy, Greg. (February, 2012). *Closing corporate loopholes, bolstering Illinois' budget.* Good Jobs First. Available at http://www.goodjobsfirst.org/sites/default/files/docs/pdf/il_loopholes.pdf

[10]For an analysis of the 2007 proposal, see McNichol, Elizabeth and Lav, Irs. (May 3, 2007). *Illinois' proposed gross receipts tax: A modified GRT could be paired with other tax changes.* Center for Budget and Policy Priorities. Available at http://www.cbpp.org/cms/?fa=view&id=330.

state government could also use this kind of tax. In fact, a state property tax has some precedent. The Illinois Department of Revenue is already involved in the administration of local property taxes, and the state directly collects a very small amount of property tax revenue (about $65 million in 2012). A few other states have major statewide property taxes. In 2012 Arkansas collected about 12 percent of state revenue from the property tax, Washington collected 11 percent, Michigan collected 8 percent, and Minnesota collected 4 percent.[11] Only Michigan has a special statewide property tax on business property.[12]

Possible revenue effects of option 3: The Illinois Department of Revenue reports a little more than $100 billion of assessed value of commercial or industrial property in the state in 2011. These classes of property were responsible for about $8 billion of local property tax in that year, compared to about $17 billion of residential property tax.[13] Assuming a relatively small statewide rate such as 1 percent of assessed value exclusively on commercial and industrial property, this tax could raise approximately $1 billion per year.

Effects on other objectives

Each of the business tax options described above could have significant effects on objectives other than revenue, although analyses of these effects are not possible without more detailed proposals and significant additional study.

Modifying the corporate tax base is expected to have two primary effects. First, businesses may change the way in which they report their income to minimize their tax burdens. They could change the timing of income (for example, slow down or speed up payments) or legal form (e.g. convert from a corporation to a partnership). The effect of such changes on economic efficiency or employment may be small, but historical experience suggests that these changes can result in significant reductions in state revenue.

Second, business may change their business practices, employment, and investment patterns, including decisions about whether to locate or expand within Illinois in order to avoid tax increases. In general, small changes in the tax base have only small effects on business practices. Recent research provides only weak evidence that movement from the one-factor to three-factor corporate tax apportionment formula lowers employment.[14]

Enacting an entirely new tax, such as a GRT or a statewide business property tax, clearly could have much more substantial impacts on Illinois' economy than changes in the corporate tax base. Economic research provides mixed evidence of the relationship between taxes and state economic performance.[15] From the point of view of economic efficiency, a major advantage of a GRT, VAT, or statewide business property tax is that these taxes would treat all businesses uniformly (instead of discriminating by corporate form). A differential tax treatment of corporate and non-corporate businesses based solely on organizational form has little to recommend it.

A second more controversial advantage of these alternative general business taxes is that they would tax business activity regardless of whether it was profitable. The current system that levies a tax based on firms' profit discourages profitable business while encouraging those that are economically marginal. To the extent that firms' profits reflect demand for their services, discouraging profitable businesses from locating in Illinois has a negative economic impact.

Distributional effects

Unfortunately, it is quite difficult to say much about the effect of changes in business taxes across the income distribution. Business taxes are likely to have their most progressive impact on income distribution if the burden of the taxes falls on relatively high-income business owners. Owners of corporate stock tend to be much wealthier than the average citizen, although recently more stock is being held in retirement portfolios and by individuals with moderate income.

Compared to a corporate income tax, different taxes on business (GRT, VAT or business property) are likely to extend to more businesses and therefore may reach more small businesses whose owners may have higher or lower incomes than do the owners

[11] Annual Survey of State Government Tax Collections. (2012). Available at http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk.

[12] See Minnesota House of Representatives Financial Analysis Department. (2012). *Statewide General Property Tax – January 2012 Update.* Available at http://www.house.leg.state.mn.us/fiscal/files/ibStatewideGeneralPropertytax_Jan12.pdf

[13] See http://www.revenue.state.il.us/AboutIdor/TaxStats/PropertyTaxStats/2011/index.htm.

[14] Merriman, David. (Forthcoming). A replication of coveting thy neighbor's manufacturing: The dilemma of state income apportionment (Journal of Public Economics, 2000). *Public Finance Review.*

[15] Mazerov, Michael. (June 17, 2013). *Academic research lacks consensus on the impact of state tax cuts on economic growth: A reply to the Tax Foundation.* Center for Budget and Policy Priorities. Available at http://www.cbpp.org/cms/?fa=view&id=3975.

of corporate stock. This point may matter little if business tax burdens fall on employees or customers. Unfortunately, it is difficult to make general statements about the conditions under which tax burdens are shifted.

Proposal to cut Illinois' corporate income tax rate

A discussion of business taxes in Illinois would not be complete without mention of the January 2014 proposal by Speaker of the Illinois House Michael Madigan. Madigan proposed to cut Illinois' corporate income tax rate from 7 to 3.5 percent.[16] Madigan's proposal would reduce revenue by about $1.5 billion per year. In the absence of other policy changes, it would deepen Illinois' already substantial budget shortfall. Yet this corporate tax cut proposal may sensibly be discussed as part of a package of reforms that raises revenue, such as the gradual shift from a corporate income tax to a GRT or VAT.

The corporate rate cut alone may be intended to reduce the efforts of businesses to negotiate firm-specific tax breaks when they consider relocation. Comprehensive statistics are not available about the cost of such negotiated tax breaks, but the total is likely to be far less than the $1.5 billion revenue cost of the proposal.

The proposed tax cut is not likely to stimulate employment in Illinois. The corporate tax base in Illinois is determined by a firm's nationwide profits and by the share of its sales that occur in Illinois. Relocation of employment by itself has no effect on a firm's corporate tax liability in Illinois.

Conclusion and summary

Businesses directly remit a large share of state taxes, but individuals somewhere necessarily bear the ultimate economic burden from these taxes. Illinois' use of business taxes is broadly similar to other states. The most important business taxes in Illinois are the local property tax, the sales tax, other excise taxes, and the corporation income tax. The corporation income tax could be modified to eliminate certain tax deductions and other similar devices, which would likely raise only a modest amount of revenue. The introduction of a new tax to supplement or replace the corporate income tax has some precedent in other states. Potential new business taxes include a gross receipts tax, value added tax, or statewide property tax. Each could raise substantial additional revenue, but the economic and distributional effects of new taxes are difficult to assess without detailed proposals and significant analyses.•

[16]Long, Ray, Cancino, Alejandra and Pearson, Rick. (January 30, 2014). Madigan proposes cutting business income tax in half. *Chicago Tribune.* Available at http://articles.chicagotribune.com/2014-01-30/news/chi-madigan-proposes-cutting-business-income-tax-in-half-20140130_1_tax-incentives-income-state-address

Further Reading

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