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Tax Policy, Tax Politics and a Graduated Income Tax

By Mike Klemens

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For two consecutive General Assembly sessions, proposals to amend the Illinois Constitution to allow implementation of a graduated income tax have failed. Proponents of a graduated rate income tax have wrapped their proposal in the mantle of "fairness," and named the proposal the "Fair Tax." They point out that only the wealthy would pay more tax, while most Illinoisans would pay less. However, even if the required Resolution passed the General Assembly, Illinois voters would have had the final say on the matter and would have to have been convinced to abandon the flat tax that has been around since the Illinois Income Tax was enacted in 1969.

This article will take a "sound tax policy-view" of both the proposal and alternatives to see whether it is possible to raise a significant amount of new taxes without amending the Constitution. For an in-depth review of the tax policy implications for a graduated rate income tax see "Graduated Income Tax Viewed from a Tax Policy Perspective," Natalie Davila, *Tax Facts 67.4*, April/May 2014.)

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

The Illinois General Assembly is getting back to work after the election season hiatus, and the need for a comprehensive solution to our state's budget woes is looming large. The "stopgap" budget passed last summer runs out, for many state functions, on December 31. No one imagines it will be easy and most observers acknowledge that the resolution will require pain on both spending and revenue sides of the equation.

This issue of *Tax Facts* looks at one of the most discussed tax hike proposals, a graduated rate income tax. Mike Klemens revisits the tax policy implications of the graduated income tax and compares it to some alternatives, like ending or reducing Illinois' nearly unique exclusion of pensions and retirement plans from taxation. Bottom line: base-broadening measures rank more favorably than a graduated rate, when scored against the principles of sound tax policy, and can also be more progressive—an oft-cited goal of graduated rate supporters.

Our second article addresses another theme that surfaces any time money is short: ending business tax credits and other incentives originally enacted in an effort to stimulate the economy. Natalie Davila looks at the Pew Charitable Trust's studies on effectively measuring the benefits and costs of these incentives. I encourage you to look at Natalie's sidebar comparing Illinois and Iowa's Research and Development Credits to see what Illinois could do differently, and to better understand why our haphazard approach is given a "trailing behind" rating by the folks at Pew. Lawmakers should have the information necessary to periodically and properly review the laws they have passed.

This paper examines the tax policy implications of changing to a graduated income tax and other alternatives against the background of Illinois' serious financial crisis. Fundamental to this exercise is the assumption that Illinois' most pressing problem is a budget that is out of balance (i.e. Illinois state government is spending more money than it is taking in) with a backlog of unpaid bills that Comptroller Leslie Munger says will grow to $10 billion by the end of the year. (See https://illinoiscomptroller.gov/news-portal/munger-unpaid-bill-backlog-to-exceed-10-billion-by-year-end/#.WA-9q_krLIU). We assume that both painful budget cuts and painful tax increases will be needed. All data comes from the publicly available income tax stratifications the Illinois Department of Revenue provides on its website.

Graduated Income Tax Proposals

There have been two parts to the proposals advanced to move from a flat tax to a graduated rate income tax. The first, yet to be passed, would be the required constitutional change to strike the reference in the Illinois Constitution: "A tax on or measured by income shall be at a non-graduated rate," which prohibits a graduated income tax. Delegates to the Constitutional Convention included that language when they drafted the 1970 Constitution to comfort voters just a year after Illinois' first income tax was enacted.

The second part, never passed because the first did not pass, involves a proposed law to tell voters exactly what those rates would be, a recognition that voters will want to know how their vote on the Constitutional Amendment would affect their taxes. Of course the legislation can be changed by statute without going back to the voters, a fact that opponents focused on.

The proposed legislation in HB 689 replaced the 3.75 percent flat tax rate with brackets. The brackets, for a married couple filing jointly, are shown in **Chart 1**. The effect of the bill according to proponents was that 99 percent of filers would pay less tax than under the current flat tax and that revenues would be increased by $1.9 billion.

CHART 1. PROPOSED TAX RATE STRUCTURE HB 689 (MARRIED JOINT FILERS)

TAX RATE	BRACKET
3.5%	$0 - $200,000
3.75%	$200,000 - $750,000
8.75%	$750,000 - $1,500,000
9.75%	More than $1,500,000

HB 689 did not pass, but before we evaluate other revenue-raising options, it is worth noting that the graduated tax proposed in HB 689 is very different from graduated taxes at the federal level or in other states. Compare the rates in Chart 1 to the more familiar structures contained in the federal tax code in **Chart 2**, where the rate increases are more gradual and spread over a larger number of brackets.

CHART 2. FEDERAL INCOME TAX RATE STRUCTURE (MARRIED JOINT FILERS)

TAX RATE	BRACKET
10%	$0 - $18,550
15%	$18,550 - $75,300
25%	$75,300 - $151,900
28%	$151,900 - $231,450
33%	$231,450 - $413,350
35%	$413,350 - $466,950
36.9%	More than $466,950

Or look at neighboring Iowa, in **Chart 3**, where the same, more gradual structure is in place, but the tax rate peaks at just under $70,000 in income.

CHART 3. IOWA INCOME TAX RATE STRUCTURE (MARRIED JOINT FILERS)

TAX RATE	BRACKET
0.36%	$0 - $1,554
0.72%	$1,554 - $3,108
2.43%	$3,108 - $6,216
4.50%	$6,216 - $13,896
6.12%	$13,896 - $23,310
6.48%	$23,310 - $31,080
6.80%	$31,080 - $46,620
7.92%	$46,620 - $69,930
8.96%	More than $69,930

The HB 689 proposal is so different from other progressive income tax schemes that it more approximates a surcharge on high income households than graduated tax rates enacted elsewhere.

If a graduated rate is not a viable option, the challenge for those seeking to use the individual income tax, at least in part, to close Illinois' cavernous budget hole becomes to devise a proposal that would:

- Raise a significant amount of new revenue,
- Avoid the delays and uncertainty involved with a vote on a constitutional amendment, and
- Conform to sound tax policy principles. (See *Principles of Sound Tax Policy* on page 12 for the principles-- best summed up as broad base, low rate taxation--used by the Taxpayers' Federation and other groups to analyze tax law proposals.)

Options

The first place to look for additional income tax revenue, particularly if you are keeping in mind the broad base/low rate mantra of good tax policy, is situations where Illinois narrows its tax base. This should be a fruitful exercise; the latest Comptroller's Tax Expenditure Report says that $4.6 billion of the $9.4 billion in state tax expenditures came from Illinois Individual Income Tax. Three of Illinois' top four tax expenditures were in individual income tax:

- $2.3 billion for untaxed retirement and Social Security income,
- $1.1 billion for the personal exemption, and
- $568 million for the property tax credit.

Let's look at them in order.

Retirement Income

The Illinois Income Tax follows the federal tax code and starts with Federal Adjusted Gross Income on Line 1. The Illinois return then makes a few adjustments for things like federal savings bonds that the IRS can tax but states cannot. Then – at line 5 on the 2015 Form IL-1040, there is a subtraction for "Social Security benefits and certain retirement plan income received if included in Line 1 (Federal AGI)." This includes payments from public and private pensions, 401(k) plans, Individual Retirement Accounts, and deferred compensation plans, whether or not the recipient is actually retired.

In other words, pensions or other retirement plan income, most of which was based on contributions that were not taxed before they were made, will be taxed by the federal government but not by Illinois. Of the 41 states that tax income, only Illinois, Pennsylvania, and Mississippi have such an exclusion. For a thorough review of the implications of this unusual treatment of retirement income see "Revisiting Exclusion of Retirement Income from the Illinois Income Tax Base," Natalie Davila, *Tax Facts 67.7*, November/December 2014.

Growing erosion

The retirement income subtraction is growing faster than the underlying tax base. Between Tax Year 2007 and 2014 the number of Illinois taxpayers claiming a retirement subtraction increased 11 percent and the value of the subtraction increased 48 percent. By comparison, in the tax base as a whole, the number of filers increased 1 percent and the tax base (Federal AGI) grew 34 percent. **See Table 1 on page 6.**

Who benefits?

The retirement subtraction heavily benefits higher income individual. The average subtraction for Tax Year 2014 – the most recent year for which the Department of Revenue has data, was $9,732 for those making with Adjusted Gross Income of $25,000 or less. The average was $89,575 for those with AGI of $500,000 or more and $106,327 for those with AGI of $1 million or more. **See Table 2 on page 6.**

Summary

The special treatment for Social Security benefits and certain retirement plan income is nearly unique in the country and different from IRS treatment. An ever growing amount of the income tax base is avoiding taxation. And the largest benefits go to the highest income earners.

Personal Exemption

The personal exemption in the Illinois Tax Code exempts from taxation a flat amount for the filer, her/his spouse, and each dependent. (The amount is tied to the increase in the Consumer Price Index; it was $2,125 for 2014 returns filed in 2015.) In effect, the exemption sets aside a certain amount of income per family member that is not taxable. As a consequence it makes the tax code slightly progressive. The fixed amount of the exemption means that as income increases the exemption represents a relatively smaller share of total income; or the effective tax rate (tax liability divided by AGI) increases as income increases. **See Table 3 on page 6.** (The rule does not hold for AGIs below $25,000, because many of those filers are students who are claimed on their parents' returns and cannot claim their own personal exemption.)

One way to look at the signifigance of the personal exemption is to examine how much it contributes to the difference between total income (measured by AGI) and the amount of income that is taxed. For Illinois households with AGI less than $25,000, the personal exemption accounts for all the difference between AGI and taxable income. For higher income households the difference is smaller.

Summary

The personal exemption is expensive, but makes the tax code slightly progressive and, because it is fixed, provides a relatively larger break for low income Illinoisans.

Property Tax Credit

Illinois allows residents to take a credit against their income tax equal to 5 percent of the property taxes paid on their principal residence. As you would expect, higher income Illinois

TABLE 1. TOTAL FILERS AND THOSE WITH RETIREMENT INCOME SUBTRACTION, 2007 AND 2014			
	2007	**2014**	**INCREASE (%)**
All Filers			
Returns	6,013,369	6,057,878	1
Total AGI	$471,926,697,996	$634,581,768,079	34
Filers with Retirement Subtraction			
Returns	1,393,619	1,545,610	11
Retirement Subtraction	$35,762,639,733	$52,810,323,997	48
Source: Illinois Department of Revenue			

TABLE 2. RETURNS WITH RETIREMENT SUBTRACTION, 2014			
AGI RANGE	**RETURNS**	**RETIREMENT SUBTRACTION**	**AVERAGE SUBTRACTION PER RETURN**
< $25,000	318,949	$3,104,123,455	$9,732
$25,001 - $50,000	295,574	$5,983,521,226	$20,244
$50,001 - $100,000	445,339	$16,385,216,536	$36,793
$100,001 - $500,000	365,548	$21,607,050,933	$59,109
$500,001 - $1 million	10,563	$858,750,323	$81,298
> $1,000,000	5,219	$554,918,978	$106,327
Source: Illinois Department of Revenue			

TABLE 3. RETURNS FILED BY ILLINOIS RESIDENTS - TAX YEAR 2014 WITH EFFECTIVE TAX RATE				
AGI RANGE	**RETURNS**	**AGI**	**TOTAL TAX**	**TAX RATE (%)**
<$25,000	2,012,541	$19,565,311,827	$770,435,877	3.9
$25,001 - $50,000	1,247,956	$45,387,155,616	$1,697,942,608	3.7
$50,001 - $100,000	1,315,107	$94,423,260,609	$3,560,091,237	3.8
$100,001 - $500,000	993,100	$167,879,553,028	$6,941,586,821	4.1
$500,001 or more	54,827	$82,824,664,986	$3,954,002,586	4.8
Source: Illinois Department of Revenue				

residents are more apt to own a home, own more expensive homes, and pay higher property taxes on those homes so they are more likely to get a credit and get, on average, larger credits. In 2014 more than nine of 10 residents with incomes over $500,000 got a credit, and that credit averaged $855. For those making $50,000 or less, one in six received a credit, and that credit averaged $150. **See Table 4 on page 8.**

During the real estate boom, as property values and property taxes paid were soaring, so did the credit. However, since 2007 the number of Illinois households claiming the credit has declined 14 percent, while (with rising property taxes) the value of the credit has increased 11 percent. However, nearly all of that growth occurred in households with an income of $100,000 or more. For top earners, the number of persons claiming the exemption increased 15 percent and the value of the credit increased 44 percent. Over the same period, for those making less than $100,000, the number and value of the property tax credit actually declined, on average. **See Table 4a on page 8.**

Summary

The property tax credit disproportionately benefits high income households and its elimination or curtailment would fall most heavily on those taxpayers.

General Tax Increase

While we are looking at the tax policy implications of HB 689 and various base broadening options, given the looming $10 billion bill backlog, let's also look quickly at the implications of a simple tax rate increase.

Because the tax is based on income, those with the most income pay the most tax. Returns including Illinoisans with the highest income (more than $500,000) account for less than 1 percent of all households, but pay 23 percent of the tax. At the other end of the spectrum, returns representing those with the lowest incomes (less than $25,000) account for 36 percent of all households and pay 5 percent of the tax. In short, high income Illinoisans already pay most of the tax. **See Table 5 on page 9.**

In arguing against allowing income tax rates to roll back from 5 percent to 3.75 percent on January 1, 2015, the Center for Tax and Budget Accountability asserted that the partial rollback would benefit high income Illinoisans. "Tax Relief from the Phase-down of the Personal Income Tax Disproportionately Goes to Illinois' Wealthiest," their report concluded. (Though unspoken, that means that when the flat rate increase was imposed it fell most heavily on the wealthiest Illinoisans.)

The widely cited Tax Foundation's State Business Tax Climate Index ranked Illinois favorably on its personal income tax burden, even when the temporary income tax increase was fully in effect. In 2014, when the tax rate was 5 percent, Illinois ranked 11th (first place was shared by the six states that have no income tax). With the partial rollback of the rate in 2015, Illinois rose to 10th place. The Tax Foundation's rankings are

TABLE 4. ILLINOIS RESIDENT RETURNS WITH PROPERTY TAX CREDIT, TAX YEAR 2014			
		PROPERTY TAX CREDIT	
AGI RANGE	RETURNS	RETURNS	AMOUNTS
<$25,000	2,012,541	175,528	$23,129,948
$25,001 - $50,000	1,247,956	351,738	$55,793,305
$50,001 - $100,000	1,315,107	764,782	$153,571,542
$100,001 - $500,000	993,100	815,648	$280,138,203
$500,001 or more	54,827	49,781	$42,572,640
ILLINOIS TOTALS	5,623,531	2,157,477	$555,205,638
Source: Illinois Department of Revenue			

TABLE 4a. ILLINOIS RESIDENT RETURNS WITH PROPERTY TAX CREDIT, BY AGI RANGE, TAX YEARS 2007 AND 2014				
	2007		2014	
	PROPERTY TAX CREDIT		PROPERTY TAX CREDIT	
AGI RANGE	RETURNS	AMOUNT	RETURNS	AMOUNTS
<$25,000	263,667	$25,887,600	175,528	$23,129,948
$25,001 - $50,000	515,744	$68,045,486	351,738	$55,793,305
$50,001 - $100,000	966,231	$170,475,175	764,782	$153,571,542
$100,001 -$500,000	679,626	$204,985,957	815,648	$280,138,203
$500,001 or more	43,171	$29,653,173	49,781	$42,572,640
ILLINOIS TOTALS	2,468,439	$499,047,391	2,157,477	$555,205,638
Source: Illinois Department of Revenue				

TABLE 5. RESIDENT TAXPAYERS' RELATIVE SHARES OF TAX LIABILITIES, TAX YEAR 2014				
AGI RANGE	RETURNS	TOTAL TAX	PERCENT OF FILER	PERCENT OF TAX
<$25,000	2,012,541	$770,435,877	36	5
$25,001 - $50,000	1,247,956	$1,697,942,608	22	10
$50,001 - $100,000	1,315,107	$3,560,091,237	23	21
$100,001 - $500,000	993,100	$6,941,586,821	18	41
$500,001 or more	54,827	$3,954,002,586	1	23
ILLINOIS TOTALS	5,623,531	$16,924,059,129		

Source: Illinois Department of Revenue

heavily based on tax rates, but Illinois also gets a boost from its flat rate tax.

Summary

Under Illinois' current flat rate tax, higher income households pay a greater share of the tax (because they have more income) than their proportion of the population, while the lowest income households pay a lesser share of the tax than their proportion of the income. To paraphrase the CTBA study, "Tax burden from a phase-up of personal income tax rates would be disproportionately paid by Illinois' wealthiest."

Turning to Tax Policy

Let's start by seeing how the proposal in HB 689 measures up to TFI's principles of sound tax policy.

Adequacy – Given Illinois' inability to pay its bills, HB 689 would certainly meet the adequacy test. It would, however, tip state and local taxation toward the income tax, which could upset the balanced revenue stream.

Stability/Predictability – States that have graduated income tax systems see sharper revenue increases during economic expansions and steeper revenue declines during economic contractions. Other states have had to cut programs more deeply or raise taxes during contractions, something Illinois has not done well. See "Does Illinois Have a Revenue Problem or a Spending Problem?" Mike Klemens, *Tax Facts, 67.4*, April/May 2014.

Equity/Fairness – This is the proponents' primary argument for a graduated tax, although vertical equity is subjective; some might argue the steepness of the tax structure in HB 689 goes too far.

Collectibility/Transparency/Simplicity – A graduated tax rate system will be less simple and transparent than a flat rate tax.

Efficiency – Similarly a graduated tax rate system will be less efficient than a flat rate tax. Opponents will argue that wealthy people will leave Illinois; there is no evidence to support that, but there can be little doubt that more than doubling the rate will encourage tax planning to legally avoid the tax.

HB 689 scores positively on only two of the five principles, and one of those is fairness/equity, arguably the most subjective of the criteria. In contrast, two of the base broadening options – ending the special treatment for pension and retirement plans and reducing or eliminating the property tax credit—and even a general tax rate increase— could all be scored positively under the TFI sound tax policy principles. (N.B. We are comparing a specific proposal for a graduated income tax increase with general principles for the other options.)

On to Tax Politics

Broadening the tax base by ending the unique treatment for taxation of public and private pensions or by eliminating or curtailing the property tax credit both represent sound tax policy. Both would fall most heavily on higher income households. The same would be true for a general tax rate increase under a flat tax.

However, none has the voter appeal of the graduated income tax in HB 689. Taxing retirement income raises taxes on 1.4 million households. Eliminating the property tax credit would hike takes on 2.2 million households. A general tax rate hike would boost taxes on 5.6 million Illinois households. **See Chart 4.**

In contrast HB 689 would cut taxes for 5.6 million households, while raising them on 56,000. In this instance, good politics is not good policy.

CHART 4. NUMBERS OF WINNERS AND LOSERS UNDER VARIOUS ALTERNATIVES

OUTCOME	RETIREMENT INCOME	ELIMINATE/LIMIT PROPERTY TAX	GENERAL TAX HIKE	HB 689
Winners	0	0	0	5,567,296
Unaffected	4,182,339	3,466,054	0	0
Losers	1,441,192	2,157,477	5,623,531	56,235

The Numbers

Retirement Income - Policymakers could, keeping with the broad base/low rate approach, end the special and nearly unique treatment that Illinois provides for retirement income. Our earlier research found that break is most significant for low income persons, so perhaps a modest amount of retirement income should be exempted from taxation – say $25,000. If Illinois allowed its taxpayers to keep the first $25,000 of retirement income tax free, that expansion of the tax base alone would have generated $1.9 billion in new state revenues at the 3.75 percent rate.

The tax hit from ending the exclusion is pretty heavy, averaging over $1,300 per filer claiming the retirement income subtraction. Phasing out of the exception over a period of years would ease the impact on those who have made plans assuming the income is not taxable.

Property Tax Credit – The property tax credit is regressive by its construction. It rewards home ownership and does nothing directly for renters. As the data shows, higher income households get bigger property tax credits.

Eliminating the credit (and ending what is effectively a state subsidy of local property taxes) would generate $562 million in additional income tax. Alternatively, by capping the credit at $200, residents would get a credit based on the first $4,000 of their property tax bill, but the person paying $4,000 in property tax would get the same income tax benefit as one paying $50,000. A $200 cap would generate an estimated $150 million in new taxes, primarily from higher income households.

General Rate Increase – Despite suggestions to the contrary, Illinois' personal income tax is not high compared to other states. (See Illinois Illustrated: A Visual Guide to Taxes & the Economy, published by the Tax Foundation and the Taxpayers' Federation of Illinois.) The tax falls most heavily on high income households (which have the most income). For each 0.5 percent increase in the tax rate, Illinois would generate $1.8 billion annually in new taxes, nearly one quarter from the top 1 percent of households.

Conclusion

Illinois is drowning in a sea of unpaid bills. Correcting the situation will require both spending cuts and tax increases. Both will be difficult to enact.

Much of the increased revenue focus has been on changing to a graduated income tax. However, advocates have been unable to accomplish even the first stage of moving to a graduated income tax system – getting the constitutional amendment through the General Assembly and before the voters. Convincing voters to entrust lawmakers with the ability to tinker with brackets and rates would be even harder.

Instead, lawmakers could achieve many of the same goals sought by the graduated rate proponents by repealing or reducing the exclusion for public and private pensions, capping or repealing the property tax credit, or raising the general tax rate. Each of these options would, like the proposed graduated income tax, fall most heavily on high income Illinois households (though not nearly as extremely). And these changes would better conform to the principles of sound tax policy. Illinoisans could celebrate the triumph of tax policy over tax politics, and Illinois could start to pay its bills again.

PRINCIPLES OF SOUND TAX POLICY

In a nutshell, sound tax policy requires a broad-based, low-rate structure. Specifically, the Taxpayers' Federation of Illinois' principles include:

Adequacy. A tax structure must raise enough revenue to properly fund government operations. Tax revenues need to reflect economic growth, which usually requires that tax collections be balanced across multiple tax types

Stability/Predictability. From the taxpayer's perspective, tax liabilities should not fluctuate dramatically from year to year. From the government's perspective, the same is true of revenues.

Equity/Fairness. Equity has two dimensions: horizontal equity and vertical equity. Horizontal equity compares similarly situated taxpayers. Vertical equity compares tax burdens across taxpayer income or wealth brackets.

Collectibility/Transparency/Simplicity. These interrelated principles apply primarily to tax administration and, although they are generally noncontroversial, are too often overlooked.

Efficiency. This is sometimes considered an aspect of equity. Taxes should be imposed without distorting economic behavior; the tax code should not pick winners and losers. Tax compliance and administration processes should not be unnecessarily inefficient and costly (which is frequently a consequence of violating the simplicity principle).

Illinois Tax Facts

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Best Practices in Evaluating State Tax Incentives: What Illinois Can Learn From Other States

By Dr. Natalie Davila

Natalie Davila is an economist with an extensive background in public finance. She was Director of Research for the Illinois Department of Revenue for 10 years.

Introduction

States continue to offer a myriad of business tax incentives with the general objective of stimulating economic growth. In Illinois, for example, almost $500 million in economic development tax incentives were identified in the most recent Tax Expenditure Report.[1] The academic literature has found little evidence that offering such incentives increases overall economic growth, but they remain popular for a variety of reasons. Frequently, incentives are used as part of a bidding war between states over firms seeking to relocate or expand. However, according to recent research, almost half of the states have not taken basic steps to produce and connect policy makers with good evidence of whether these tools deliver a strong return on taxpayer dollars.[2]

Evaluating Tax Incentives

In April 2012 the Pew Center on the States released a study, *Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth,* the purpose of which was to provide comparative information on how states were using data driven analysis to guide economic development incentive policy.[3]

> "In the wake of the Great Recession, states have to do more with less—so every dollar counts. Lawmakers are looking to get their fiscal houses in order, deliver critical services more effectively and at a lower cost, and invest where the proven returns are greatest, in areas that will generate dividends over the short and long term."[4]

Table 1 on page 14 shows how Pew categorized the states' incentive evaluation process.

The overall findings of the 2012 Pew Report were that no state regularly and rigorously tested whether tax incentives are working and ensured that lawmakers were considering such information when deciding whether or not to authorize tax incentives, how much to budget for the foregone revenue, or what kind of businesses should get them. The report suggested that often states that have conducted rigorous evaluations of some incentives virtually ignore others or assess them infrequently, while other states regularly examine tax incentive investments but not thoroughly enough.

TABLE 1. CRITERIA AND CLASSIFICATIONS USED IN PEW STUDY - EVIDENCE COUNTS			
	Scope: How Are States Doing?	**Quality: How Are States Doing?**	**Overall: How Are States Doing?**
Leading the Way	States that informed policy choices with reviews of all major tax incentives.	States whose best evaluation measured economic impact and drew clear conclusions.	States meeting both criteria for scope of evaluation and/or both criteria for quality of evaluation
Mixed Results	States that reviewed all major tax incentives but fell short in using the data to inform policy choices.	States whose best evaluation either measured economic impact or drew clear conclusions, but not both.	States meeting only one of the criteria for scope and/ or quality of evaluation.
Trailing Behind	States that did not review all major tax incentives or use data to inform policy choices.	States that either did not conduct any evaluations or whose best evaluation did not meet either criterion.	States not meeting any of the criteria for scope or quality of evaluation.

The report concluded that 13 states were leading the way in generating much-needed answers about tax incentives' effectiveness. Twelve states had mixed results. The other 25 states, along with Washington, D.C., were trailing behind. These results were based on a review of nearly 600 documents along with interviews with more than 175 government officials and experts to examine how—and how well—states gauge the effectiveness of their tax incentives. It is important to note that the Pew study does not speak to whether tax incentives for economic development are good or bad. Rather, the study examines the effectiveness of each state's evaluations, focusing on whether, and to what degree, they: inform policy choices; include all major tax incentives; measure economic impact; and draw clear conclusions.

Table 2 presents information from the Pew report on Illinois and other Midwestern states. The table also includes updated information published in a Brief by Pew in January 2015.[5] In the 2012 report, three states (Iowa, Missouri, and Wisconsin) were considered leading, two states had mixed results (Kentucky and Michigan), while the remaining two states in our comparison group (Illinois and Indiana) were considered trailing. By the time the 2015 Pew brief was published, Indiana had conducted significant research in the area of data-driven analysis of economic development tax incentives and given the original criteria is no longer considered trailing, leaving Illinois as the only Midwest state remaining in the trailing category. In September 2016, Pew issued an update which discussed five states who had improved their evaluation of incentives during the last fiscal year. Illinois was not one of them.[6]

TABLE 2. HOW WELL ARE SURVEY STATES USING DATA-DRIVEN ANALYSIS TO GUIDE ECONOMIC DEVELOPMENT INCENTIVES?				
State	**Incentive Reviews Used to Inform Policy Makers**	**Evaluations Measure Economic Impact and Draw Clear Conclusions**	**Original Overall Grade**	**Grading as of January 2015[7]**
Illinois	Trailing	Trailing	Trailing	Trailing
Indiana	Trailing	Trailing	Trailing	Leading
Iowa	Leading	Mixed	Leading	Leading
Kentucky	Trailing	Mixed	Mixed	Mixed
Michigan	Trailing	Mixed	Mixed	Mixed
Missouri	Mixed	Leading	Leading	Leading
Wisconsin	Trailing	Leading	Leading	Leading

In addition to Pew, the Government Finance Officers Association (GFOA) offers specific recommendations on how tax incentives should be evaluated.[8] First, goals and objectives must be clearly defined. Second, various techniques on how the program is measured should be established. This may include: a cost/benefit analysis; an evaluation of tax base impact; analysis of the impact of a project on existing businesses; a determination of whether the project would have proceeded if the incentive were not provided; and a list of required documentation for the economic development application and the officials who are a part of the review team. As illustrated in the above tables, Illinois falls short of meeting these criteria.

Iowa – Example of Best Practices

According to Pew, Iowa is one of only four states (Arizona, Oregon and Washington being the others) that have integrated evaluation of their major incentives into the policy process, ensuring that those investments are regularly reviewed. As a result, Iowa offers valuable examples for Illinois to learn from.

During the summer of 2004, the State of Iowa initiated a new way of developing the state's budget process based on the seminal work by David Osborne and Peter Hutchinson.[9] This new budget-making process emphasized improved accountability and responsiveness to the public through the establishment of measurable objectives for each policy area and the creation of competition for funding.

The Iowa Department of Revenue submitted a budget proposal to establish a Tax Credit Tracking and Analysis Program (TCTAP). The primary rationale for proposing TCTAP was the recognition of a trend toward funding an increasing array of state initiatives through tax credits rather than through appropriations. Prior to 1980, Iowa offered only one tax credit. By tax year 2005, there were twenty-two tax credits that could be taken against the individual income tax alone. The TCTAP proposal incorporated a number of features unique among Iowa State government programs at the time. Foremost it addressed the objective of accountability through measurable results and the analysis of impacts on the State's economy. Second, it recognized the need for collaboration among numerous departments of State government. Third, it identified the need for a comprehensive database that would contain information on both tax credit awards and claims. Finally, it proposed the development of a means for tracking tax credit transfers and tax credit claims made by the owners of pass-through entities.

Funding for the TCTAP began in Fiscal Year 2006. One critical component of the initiative was cooperation of many departments, facilitated by establishing an inter-departmental steering committee (comprised of representatives from other state departments with responsibilities for tax credits). This Legislative Tax Expenditure Committee was authorized to evaluate any tax expenditure available under Iowa law and assess its equity, simplicity, competitiveness, public purpose, adequacy, and extent of conformance with the original purposes of the legislation that enacted the tax expenditure, as those issues pertain to taxation in Iowa. The Committee was also required to submit a report to the Legislative Council containing the results of the review. One requirement of the report was that it contain a statement of the policy goals of the tax expenditure and a return on investment calculation for the tax expenditure. The enabling legislation also suggested that the report include a return on investment calculation to help reach a conclusion as to whether the benefits of the tax expenditure are worth the cost to the state of providing the tax expenditure. Finally, it was suggested that the report include recommendations for better aligning tax expenditures with the original intent of the legislation that enacted the tax expenditure. Since 2006, the Department has prepared and published status and contingent liability reports annually and has conducted and published 28 individual evaluation studies – all of which can be found on their web site.[10]

We have selected one economic development tax incentive that exists in Illinois and Iowa, the Research and Development ("R&D") Credit, to illustrate how the evaluation process differs in the two states. A short report produced by staff at the Illinois Department of Revenue ("IDOR") in 2011 presents some summary statistics about the R&D credit. The one-page presentation of data includes only the amount of credits used and earned On the other hand, Iowa has issued two major reports evaluating the credit. [See *Illinois v. Iowa—a Case Study*, on page 22 for more detail.]

Illinois - Moving in the Right Direction?

In Illinois, the Comptroller reports tax expenditure information, with totals for each major incentive, on an annual basis.[11] In addition, the legislative Commission on Government

Forecasting and Accountability and IDOR have released ad hoc reports over the years.[12 13] There is no systematic analysis or evaluation of Illinois' tax incentives. However, Illinois has made some improvements to tax incentive data collection in recent years. These are discussed below.

Enterprise Zones

Illinois' Enterprise Zone Program is designed to stimulate economic growth and revitalization in economically depressed areas of Illinois through state and local tax incentives, regulatory relief and improved governmental services. Businesses locating or expanding in an Illinois enterprise zone may be eligible for a variety of state and local tax incentives.[14] On August 7, 2012, the Governor amended the Illinois Enterprise Zone Act by signing Senate Bill 3616 into law (Public Act 97-0905). This legislation included a number of revisions to the enterprise zone program, but most importantly for purposes of this article, it created new benefits received reporting requirements.

Businesses in enterprise zones are now required to report annually on the total tax benefits received by incentive category, job creation, job retention, and capital investment. The Department of Commerce and Economic Opportunity ("DCEO") makes this this information available by zone as part of their annual reports on the Enterprise Zone program, which already includes job and capital investment information. Proponents of the legislation claimed that it would provide additional data for policymakers to evaluate economic development incentives provided to businesses through Enterprise Zones.[15] It was hoped that these measures would be the first step toward making informed policy decisions on the effectiveness of the enterprise zone program.[16] While a move in the right direction, this reporting requirement falls short of the Pew criteria in several ways including that it relies solely on self-reporting. In addition, the data has not been used to conduct net economic impact analysis nor has it been fed into policy making.

Local Government Revenue Sharing Agreements

Revenue sharing agreements (sometimes called rebate agreements) are between a local government – such as a city or county – and a business or other entity, such as a store, a developer or a consultant. Under such an agreement the local government agrees to pay a sum or percentage of sales tax dollars generated from retail sales back to the business entity. Local governments are required to report all revenue sharing agreements, effective January 1, 2013. In July of that year it became possible to use a searchable database on the IDOR web site to access information contained in those reports: the name of the local government; business name and address; the terms of the agreement between the business and the local government; the length of the agreement; and a list of other businesses or local governments who may benefit from the agreement.

The Chicago Metropolitan Agency for Planning (CMAP) issued a report analyzing the rebate data for Northeastern Illinois in July 2013, followed by an update in January 2014, and again in May 2016.[17,18,19] The analysis finds that many communities in the region have committed significant funds toward sales tax rebates. In northeastern Illinois, 13 communities currently have maximum rebates of more than $10 million each. In other communities, the sales tax rebate agreements currently in place will last for more than 20 years with no maximum rebate. The most recent CMAP update finds that between 2013-15 the region's total sales tax rebates increased from 343 to 359. The region's committed rebate total has grown from $433 million to $495.9 million. Mapping the updated data indicates that sales tax rebates are more prevalent on or near municipal boundaries as well as on state and county roads. While a good first step, this reporting falls short when compared with the criteria set forth by Pew. For example, attempts should be made to determine how much of the funds committed were actually rebated and most importantly the net economic impact of these rebates should be measured.

EDGE Credit

The EDGE program is designed to offer a special tax incentive to encourage companies to locate or expand operations in Illinois when there is active consideration of a competing location in another State. The program can provide tax credits to qualifying companies, to be used mostly against corporate income taxes over a period not to exceed 10 years.[20] Currently, to participate in the program, a company must provide documentation that attests to the fact that at least one other state may be more competitive, and agree to make an investment of at least $5 million in capital improvements and create a minimum of 25 new full time jobs in Illinois. For a company with 100 or fewer employees, the company must agree to make a capital investment of $1 million and create at least 5 new full time jobs in Illinois. The amount of the maximum tax credit is negotiated on a case-by-case basis. The tax credits could be as high as the amount of tax receipts collected from the Illinois income taxes paid by newly hired and/ or retained employees of the firm pertaining to the project.[21]

Starting in January 1, 2004, DCEO was required to comply with Public Act 93-552, the Corporate Accountability for Tax Expenditures Act, which was signed into law on August 20, 2003.[22] This Act requires any recipient that receives economic development assistance from a state granting body, as defined by the Act, to report annually on the progress of the employment commitments for the project.

Publication of this information was a good first step. However, in the 12 years since the Act was signed, no comprehensive analysis of the EDGE program has been conducted. Current reporting falls short when compared with the Pew criteria. Most importantly, the data should be used to analyze and determine the net economic impact of these agreements on the state economy (for a discussion of net economic impact see Davila, Persky and Klemens, Review Magazine, May 2015[23]).

Findings, Suggestions and Recommendations

Since publication of the 2012 Pew report, we find a trend among many states toward increasing the quantity and quality of evaluations of tax incentives and attempts to formally integrate the results into policy and budget deliberations.[24] While Illinois has improved some data collection efforts since the original Pew report, the state's efforts fall short of meeting the Pew criteria. Below are some suggestions on how Illinois can improve its ranking in terms of how the state evaluates tax incentives.

- The legislature could build on the work of the House Revenue & Finance and State Government Administration Committees, which conducted a number of joint hearings in early 2014 to gather facts on Illinois' tax climate. They received information on existing conditions from a wide variety of sources, and issued a preliminary report[25], but reached few conclusions and did not make any specific tax policy recommendations regarding evaluating tax incentives. These same committees, or something similar but with Senate participation, could develop legislation (along with appropriating the necessary funding), such as was crafted in Iowa.[26]
- We recommend that any evaluation of Illinois' various tax credits and incentives, whether pursuant to a reconstituted House joint committee effort or otherwise, include public and private sector participants.
- Illinois' existing credit and incentive reporting measures should be enhanced, in order to properly evaluate the programs. EDGE information reported by DCEO should include credits originally contemplated (pursuant to negotiated EDGE agreements), credits earned (based on the taxpayer's activities), and credits actually used to reduce tax liability, and this information should be made available on regional, industry category, and size-of-business bases. Similarly, we suggest that IDOR verify the self-reported Enterprise Zone data as part of the Department's audit procedures. And while it is enlightening to see how many rebate agreements have been entered into and the maximum dollar amount of each agreement, the actual annual cost of these agreements should be included in the rebate reports. Once this sort of information is available on these and other programs, statistical analysis could be used to compare the net economic performance of firms receiving and using credits and incentives in comparison to similarly situated firms that did not, and to determine the ***net economic impact*** of these local rebate agreements on the region and the state – not just the local community.[27]
- Lastly, some Illinois tax incentives contain statutory expirations or "sunset" provisions. Currently, this provision has no relationship with scheduled evalua-

(see page 21)

tions and only generates uncertainty within the taxpayer community. We recommend that Illinois government officials redefine this provision, using it instead to establish evaluation schedules. This would provide policymakers with the opportunity to decide whether programs should be extended, altered, or allowed to end, while giving taxpayers a level of confidence that tax laws will only change after a thorough examination.

Illinois offers a number of tax incentives. In order to determine whether these programs are an effective economic tool, as their supporters believe, or unnecessary give-aways, as their detractors claim, we need to develop a process for systematically analyzing and evaluating the incentives and their consequences. The Pew criteria, measures taken in other states, and the recommendations above, can all provide useful guidance for Illinois to build on the recent developments in this area.

ENDNOTES

[1] http://ledger.illinoiscomptroller.gov/ledger/assets/File/TaxExpend/2015%20Tax%20Expenditure%20Report.pdf

[2] Http://www.pewtrusts.org/~/media/legacy/uploadedfiles/wwwpewtrustsorg/reports/economic_mobility/PewEvaluatingStateTaxIncentivesReportpdf.pdf

[3] http://www.pewtrusts.org/~/media/legacy/uploadedfiles/wwwpewtrustsorg/reports/economic_mobility/PewEvaluatingStateTaxIncentivesReportpdf.pdf

[4] http://www.pewtrusts.org/~/media/legacy/uploadedfiles/wwwpewtrustsorg/reports/economic_mobility/PewEvaluatingStateTaxIncentivesReportpdf.pdf, page iii.

[5] http://www.pewtrusts.org/~/media/Assets/2015/01/StateTaxIncentivesBriefJanuary2015.pdf?la=es

[6] http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/14/tax-incentive-evaluation-in-2016-in-law-and-practice

[7] http://www.pewtrusts.org/~/media/Assets/2015/01/StateTaxIncentivesBriefJanuary2015.pdf?la=es. Revised grading based on findings contained in the updated study and verified through e-mail correspondence with Pew.

[8] http://www.gfoa.org/evaluating-and-managing-economic-development-incentives

[9] The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis, David Osborne and Peter Hutchinson, 2004.

[10] https://tax.iowa.gov/report/Background?combine=Analysis%20Program; https://tax.iowa.gov/report/Contingent-Liabilities; and https://tax.iowa.gov/report/Evaluations?combine=Study

[11] http://illinoiscomptroller.gov/resources/reports/tax-expenditure/

[12] http://cgfa.ilga.gov/upload/2014januaryillinoistaxincentivesupdated012914.pdf,

[13] http://tax.illinois.gov/AboutIdor/TaxResearch/ILBusTaxIncectives.pdf

[14] DCEO website

[15] http://www.cmap.illinois.gov/about/updates/-/asset_publisher/UIMfSLnFfMB6/content/enterprise-zone-extension-and-reforms-signed-into-law

[16] http://www.cmap.illinois.gov/about/updates/-/asset_publisher/UIMfSLnFfMB6/content/enterprise-zone-extension-and-reforms-signed-into-law

[17] http://www.cmap.illinois.gov/documents/10180/82875/FY14-0009+LOCAL+ECONOMIC+INCENTIVES+REPORT.pdf/51b8f555-4579-42df-8667-87587fcc14f1

[18] http://www.cmap.illinois.gov/about/updates/-/asset_publisher/UIMfSLnFfMB6/content/sales-tax-rebate-database-analysis-highlights-prevalence-of-rebate-agreements-in-metropolitan-chicago

[19] http://www.cmap.illinois.gov/about/updates/policy/-/asset_publisher/U9jFxa68cnNA/content/sales-tax-rebates-remain-prevalent-in-northeastern-illinois

[20] Certain exceptions to this rule have been made where companies meeting certain criteria have been granted credits against other tax liabilities

[21] Economic Development for a Growing Economy Tax Credit Act, 35 ILCS 10/5-1 et seq.

[22] http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2441&ChapAct=20%26nbsp%3BILCS%26nbsp%3B715%2F&ChapterID=5&ChapterName=EXECUTIVE+BRANCH&ActName=Corporate+Accountability+for+Tax+Expenditures+Act%2E

[23] https://www.iml.org/page.cfm?key=15519

[24] For example, the author was on a discussant on a panel where states discussed improvements they had make to their processes as a result of their ranking in the Pew Study. http://www.taxadmin.org/13rev_est

[25] http://ilga.gov/house/committees/98Documents/RevenueAndFinance/Hearing20140528/Report%20on%20Findings%20May%2028%202014.pdf

[26] https://www.legis.iowa.gov/DOCS/LSA/IntComHand/2012/IHMJD000.PDF

[27] For further explanation of the difference between gross and net economic impact see Davila, Persky and Klemens, Review Magazine, May 2015. https://www.iml.org/page.cfm?key=15519

Illinois v. Iowa—A Case Study

The differing tax incentive evaluation processes in Illinois and Iowa are perhaps best illustrated by examining one incentive that exists in both states, the Research and Development ("R&D") Credit.

A short report produced by Illinois Department of Revenue staff in 2011 contains some summary statistics about the R&D credit. The one-page presentation of data includes the amount of R&D credit earned (but not the amount actually used), and the total amounts of credits used and earned in increments of 10 firms, although this is not broken down by specific credit type. The main conclusion is that the amount of credits used and earned is heavily concentrated among a few firms. Other government agencies in Illinois publish reports on incentives and tax expenditures periodically that briefly describe the R&D credit and the "impact" of the credit (meaning the total amount used by taxpayers to reduce their tax liabilities) in a particular year. None of these reports attempts a broader analysis of the full economic impact of the credit, or whether it is achieving its stated goals.

On the other hand, Iowa has published two major reports evaluating the state's R&D credit, in 2008 and 2011. The 137-page 2011 "Iowa's Research Activities Tax Credit: Tax Credits Program Evaluation Study" consists of five main research sections:

1. A discussion of research tax credits in the United States and throughout the 50 states.
2. A literature review on the impacts of research tax credits and economic growth including a discussion of research expenditures across the United States
3. An analysis of Iowa research activities tax credit claims, including information on what types of companies earn and use the credit, by various characteristics such as firm size, industry, size of credit claimed, and location. Section 3 also contains information on how much qualified research was conducted in Iowa by these firms and examines the relationship between wages paid in firms conducting research.
4. Analysis of a survey of companies who carry out research in Iowa conducted by the Iowa Department of Revenue (the survey had a 37 percent response rate (414 firms)). The survey was distributed to research-conducting firms that did and did not claim the R&D credit to not only learn more about the companies that had recently taken advantage of the credit but also how they differed (if at all) from similar companies who did not. Questions were designed to learn more about job creation, in what other states recipients conducted research, research outcomes (e.g., patents or products produced in Iowa), and how important the tax credit is for companies when making research decisions.

5. A comparison of the Iowa credit and other states' credits by applying Iowa's credit rules and those of neighboring states to a hypothetical large, multi-state research firm. The comparison finds that Iowa's refundable credit and the flat credit rate result in the highest credit of all Midwest states.

The report makes no specific recommendations in order to allow legislators to come to their own conclusions about the effectiveness of the program and what could be done to improve it. It does, however, contain a number of interesting observations:

- The data did not show that companies claiming the credit pay higher average wages to employees compared to companies in the same industry with no credit claims.
- However, for companies responding to the survey, the average annual wage of $60,877 paid to research employees in the most recent tax year was much higher than Iowa's average annual wage of $37,397 for 2010.
- Companies with credit claims reported a higher share of production in Iowa but a lower share of sales in Iowa compared with similar companies who did not claim the credit.
- 89.2 percent of companies with a recent credit claim reported conducting research in Iowa during the most recent tax year compared with just 15.5 percent of those not claiming the credit.
- 65 percent of companies performing research have been successful in creating at least one new product or service line in the preceding four years. As a result of developing new product or service lines, 87 percent of companies added new employees.
- Of the companies identified as starting business in Iowa in 2006 or later, just over one percent were identified as making a credit claim through tax year 2009, indicating that the credit is not heavily utilized by start-up companies.

In other words, the report suggests that the credit contributed to positive impacts on production levels, the development of new product or service lines, and resulting increases in employment. In addition, the credit is not being utilized by small businesses, perhaps because they were either unaware that it existed or felt it took too much effort to qualify for it.

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