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ISSUE BRIEF

Recommended Changes to Illinois Tax Expenditures, FY 2022

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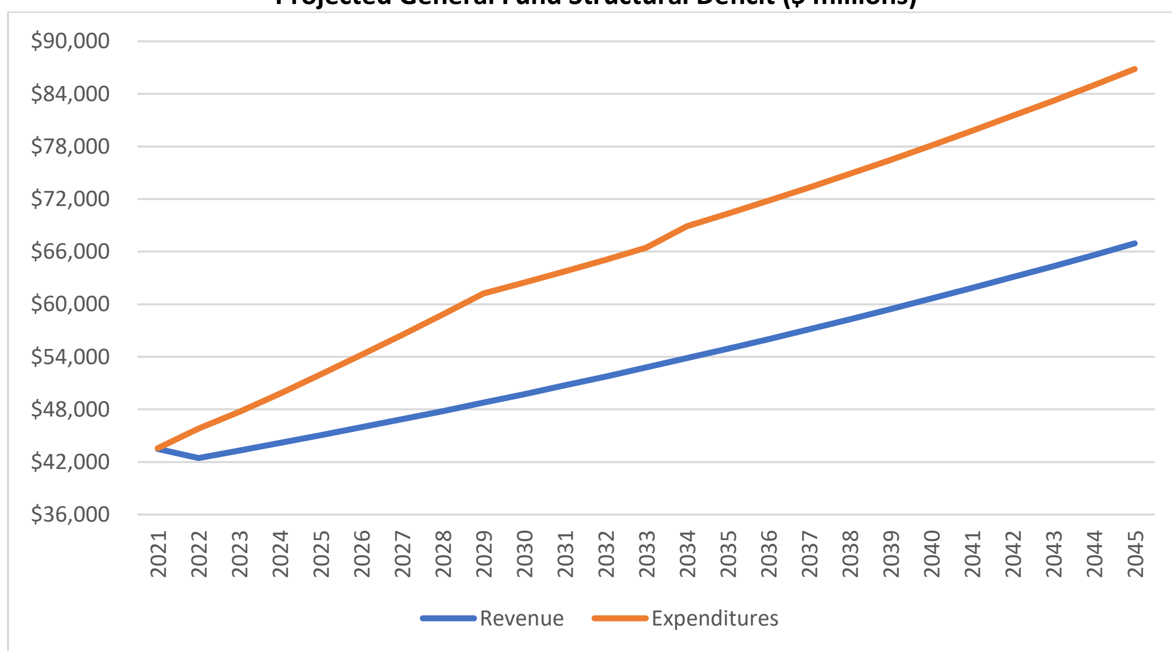
1. Given the State's Structural Fiscal Problems, Governor Pritzker's Proposal to Generate New Revenue by Eliminating Ineffective Business Tax Expenditures Constitutes Good Public Policy

Flaws in both the mix and design of the taxes Illinois imposes have combined to create a fiscal system that fails to generate annual revenue growth that is sufficient in amount to cover the cost of providing the same level of public services from one fiscal year into the next—even during a normal economy. This is known as a "**structural deficit**." The structural deficit in Illinois is so significant that, despite cutting real spending on services over the last two decades, the accumulated deficit in the state's General Fund never-the-less continued to increase over that sequence.[1] **Figure 1** is a graphic depiction of how the structural deficit in the Illinois General Fund is projected to grow into the future—assuming the state was starting with a balanced budget in FY 2021.

Figure 1
Projected General Fund Structural Deficit ($ millions)



Source: CTBA analysis of Illinois General Fund budgets, COGFA pension reports

Since the state is projected to have a material accumulated deficit of anywhere between $8.45 billion and $3.45 billion at the end of FY 2021 (depending on what the state does with the $7 billion it is slated to receive in federal relief under the American Rescue Plan Act, it is obviously not actually starting with a balanced budget.[2] The structural deficit model simply measures the rate of growth in the deficit over

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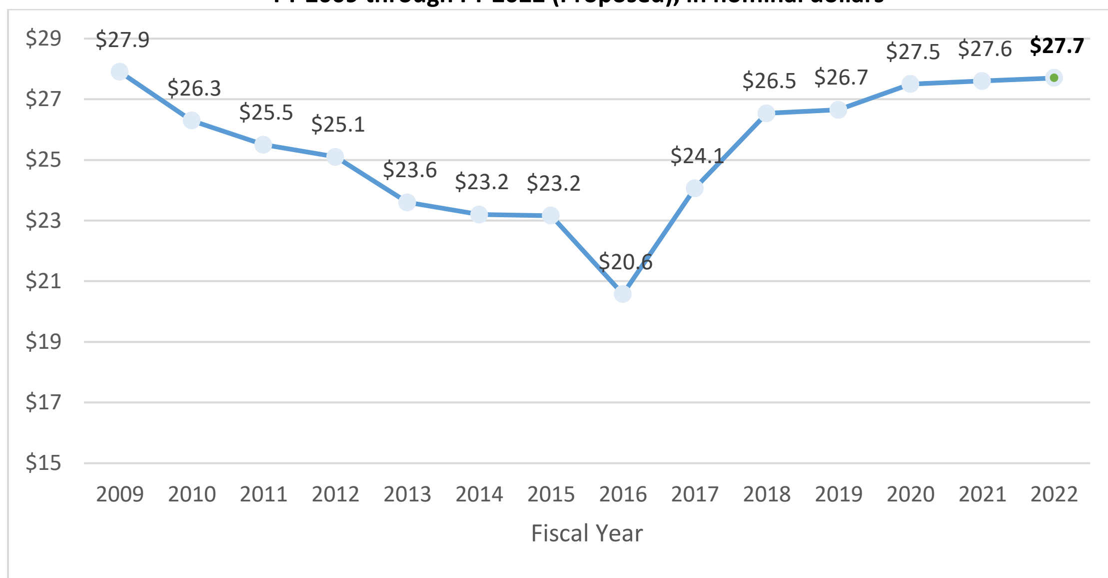
time, not the actual dollar value of the deficit in any given year. The dollar amount of a deficit in a given year is the accumulated deficit for that year.

In general, to address a structural deficit, either real spending on services has to be cut, revenue has to be raised, or some combination thereof has to be enacted. As things stand now, cutting spending on services would not be the right way to address the structural deficit, for one compelling reason: Illinois has already been disinvesting in current services for an extended period of time.

In fact, as shown in **not tell** the whole story.
Figure 2, the $27.7 billion in net, total General Fund spending on current services proposed by the governor for FY 2022 is less in nominal, non-inflation-adjusted dollars than such spending actually was 13 years ago in FY 2009—at the end of the Great Recession.[3] But that does not tell the whole story.

Figure 2
General Fund Budget Net Service Spending
FY 2009 through FY 2022 (Proposed), in nominal dollars



Source: CTBA analysis of historical GOMB budgets, FY 2009 through FY 2022.

The disinvestment in core public services has gone on for so long now that net appropriations for current services are scheduled to be 22.3 percent less under the FY 2022 General Fund Budget Proposal made by Governor Pritzker (the **"FY2022 GF Proposal"**) than they were two decades ago in FY 2000.[4]

That is problematic, given that 96% of all General Fund service expenditures go to covering the four core policy areas of: Education (Pre-K, K-12, and Higher Ed); Healthcare; Human Services; and Public Safety.

To address some of the shortcomings that have created the structural deficit in the state's fiscal system, the FY 2022 GF Proposal includes a number of initiatives designed to generate new revenue for the General Fund. Key among these are initiatives that would:

(i) eliminate or modify a number of tax breaks—which are more accurately described as "**tax expenditures**"—the state currently grants to corporations, to generate some $932 million in General Fund revenue for FY 2022; and
(ii) "decouple" Illinois from tax expenditures granted to businesses by the federal government, that cannot be expected to generate any benefit in the state, but would cause the loss of anywhere from $500 million to $1 billion in annual General Fund Revenue.[5]

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2. Why Business Tax Breaks Should be Described as "Tax Expenditures"

Tax breaks for businesses are more appropriately described as "**tax expenditures**" because they essentially constitute indirect spending by the government implemented through the tax code, generally for one of two reasons, either: (i) to help fund a private business's production of a public good or service; or (ii) to avoid inefficient "tax pyramiding," which happens when the same transaction is taxed multiple times as it flows though the economy, resulting in taxes being layered on top of taxes.

Tax expenditures to produce a public good are effectively similar to direct expenditures because they involve the utilization of public taxpayer dollars to fund the delivery of the public good or service in question. In the case of a direct expenditure, government collects tax revenue from taxpayers and then spends that revenue to pay for delivery of a public service. As indicated previously, in Illinois, well over $9 out of every $10 of General Fund spending on services goes to the four, core areas of: (i) Education (38%); (ii) Healthcare (26%); (iii) Human Services (25%); and (iv) Public Safety (7%).[6]

In the case of a tax expenditure, government allows a private sector business to keep tax revenue which that business otherwise would have had to pay, in exchange for that business utilizing the retained revenue to fund delivery of a public good. Economic development in the form of job creation is typically the public good that private businesses are expected to provide in exchange for receiving public subsidies in the form of tax expenditures.

Whether or not a particular business tax expenditure is actually creating the anticipated economic benefit is a legitimate inquiry for state government to make. After all, if a particular tax expenditure did not exist, the state would be collecting the associated revenue, which then would be available to fund current General Fund services.

Given that the vast majority of direct General Fund spending on services goes to the aforesaid core areas of Education, Healthcare, Human Services and Public Safety, **it is appropriate for the state to eliminate tax expenditures that are not creating the anticipated public good,** so that the underlying taxpayer money could be spent more effectively on funding these core current services. That is especially the case now, when the state is suffering from a long-term structural deficit.

3. Eliminating Tax Expenditures in FY 2022

The FY 2022 GF Proposal relies on generating $932 million in new, recurring revenue by eliminating the following business tax expenditures:

i. Cap Corporate Net Operating Loss Deductions Allowed under Section 207 of the Illinois Income Tax Act for Next Three Years at $100,000 Per Year ($314 million)

If enacted, this proposal would limit the amount of net operating loss deductions that a business could claim under the Illinois Income Tax Act ("**IITA**") in any single year to $100,000, for each of the next three years.[7] Estimates are that this proposal would not impact 80 percent of Illinois corporate income taxpayers, and that it will increase revenue by $314 million for each of the three fiscal years that begin with FY 2022.[8]

This tax expenditure should be eliminated, because the research shows there is no statistically meaningful correlation between tax policy changes and job or economic growth, hence elimination of this tax expenditure cannot be expected to create any economic harm for the state, while continuing to provide this tax expenditure is highly unlikely to generate any public good in the form of job growth. Indeed, the Congressional Budget Office found that an increase in demand for what a business sells is the sole factor that had a statistically meaningful correlation with incentivizing a business to hire more workers.[9]

ii. Roll Back the 100 percent Foreign-Source Dividend Deduction permitted under the Federal Tax Cuts and Jobs Act to Align with Standard Treatment of U.S.-Source and Domestic Dividends in Internal Revenue Code Section 243 ($107 million)

Sections 245A, 250 and 951A, of the federal Tax Cuts & Jobs Act ("**TCJA**") created a new, 100 percent dividend deduction for the "foreign-source" portion of foreign dividends, as well as a new, 50 percent deduction for global intangible low-taxed income ("**GILTI**").[10] If instead of allowing such significant deductions for these items, the deductions allowed for both foreign-source dividends and GILTI were aligned with the deduction permitted for domestic dividends of 50 percent, Illinois would realize an estimated $107 million more in corporate income tax revenues for the General Fund—all while still permitting corporate taxpayers to take advantage of the standard deductions authorized under Internal Revenue Code ("**IRC**") Section 243 for domestic dividends.[11]

This tax expenditure should be eliminated because it is highly unlikely it is generating any public good in the form of new job growth, given the lack of a statistically meaningful correlation between tax policy changes and job or economic growth cited in subparagraph (i) above. For the same reasons, it is unlikely elimination of this tax expenditure would result in any economic harm to the state.

iii. Roll Back Federal TCJA 100 Percent Accelerated Depreciation Deduction to Align with Standard Treatment of Depreciation in IRC Section 168 ($214 million)

This proposal would amend Section 203 of the IITA to require business taxpayers to add-back into their state-level taxable income, the difference between the 100 percent depreciation deduction allowed under subsection (k) of IRC Section 168 (which was created under the TCJA), and the standard depreciation deduction amount(s) allowed under the original provisions of IRC Section 168.[12] It is estimated this will generate $214 million more in corporate income tax revenue annually, beginning in FY 2022.[13]

This tax expenditure should be eliminated because it is highly unlikely it is generating any public good in the form of new job growth, given the lack of a statistically meaningful correlation between tax policy changes and job or economic growth cited in subparagraph (i) above. For the same reasons, it is unlikely elimination of this tax expenditure would result in any economic harm to the state.

iv. Reverse Several Recent Illinois Tax Changes ($209 million)

This proposal would eliminate the following business tax expenditures that passed into law in 2019, as part of PA 101-0009: the add-on income tax credit for qualifying construction job payroll expenditures; the repeal of the corporate franchise tax; and the right to include production-related tangible personal property in the Manufacturing Machinery and Equipment Exemption from Illinois sales taxes.[14] Collectively, it is estimated that elimination of the preceding three tax expenditures will generate $102 million annually in additional corporate income tax revenues, beginning in FY 2022.[15]

These tax expenditures should be eliminated because it is highly unlikely, they are generating any public good in the form of new job growth, given the lack of a statistically meaningful correlation between tax policy changes and job or economic growth cited in subparagraph (i) above. For the same reasons, it is unlikely elimination of these tax expenditures would result in any economic harm to the state.

That said, the franchise tax was highly unpopular with the business community and it may be politically difficult to eliminate its repeal. Moreover, it could be claimed that the production-related tangible personal property exemption is needed to avoid tax pyramiding, as the final product that results from the manufacturing process in question will be taxed when sold to the final consumer thereof.

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Additionally, the governor proposes to continue rolling back various sales tax exemptions for special motor fuels that began in 2017 and 2019. This rollback is projected to generate $107 million in various General Fund tax revenues that will be realized commencing in FY 2022.[16]

This initiative should be enacted, given it does not constitute a change in policy but rather it merely expedites the schedule for implementing existing policy.

v. Cap Retailer's Discount ($73 million)

Under current state law, Illinois retailers are allowed to keep 1.75 percent of the sales tax they collect and remit to the state as an administrative fee.[17] This was initially intended to reimburse retailers for their out-of-pocket costs of collecting sales taxes for the state. Only 26 states of the 45 that impose a sales tax nationally has such a program.[18] Most states with this tax expenditure limit or cap it in some way.[19]

The governor proposes to limit the total amount that a retailer could retain under this tax expenditure to $1,000 per month.[20] Setting the cap that high effectively means the vast majority of Illinois retailers—nearly 99 percent—would not be affected.[21] It is estimated that eliminating this tax expenditure would generate $73 million annually in increased sales tax revenue, beginning in FY 2022.[22]

Capping this tax expenditure as proposed makes sound fiscal sense, as the benefit currently provided significantly exceeds the costs it was intended to address.

vi. Limit Tax Credit For Private Scholarships ($14 million)

In 2017, Illinois created a program that grants an income tax credit to individuals and businesses that contribute to scholarship funds for private schools in an amount equal to 75 percent of any such contribution.[23] The governor proposes to reduce this credit to 40 percent of the amount contributed, to better match the allowable credit at the federal level. It is estimated this will generate an annual increase in income tax revenue of $14 million, beginning in FY 2022.[24]

Reducing this tax expenditure as proposed is sound policy for four reasons:

First, it is questionable whether any public taxpayer money should be used to subsidize private schools for many reasons, not the least of which is private schools can discriminate when admitting students, while public schools cannot.

Second, public education in Illinois is underfunded by close to $7 billion, so diverting public taxpayer money away from the state's underfunded public education system makes no sense.[25]

Third, this tax expenditure is subsidizing decisions parents make to send their children to private schools that would have been made in any event, even without the public subsidy, which means the public subsidy is not generating any public good or service.

Fourth, the research shows that public schools do a better job of educating low-income and minority students than do private schools,[26] so subsidizing the choice to send such children to private schools may in fact be counter-productive from an educational standpoint.

4. Decoupling from Federal CARES Act Tax Breaks

Part of the federal economic stimulus created under the Coronavirus Aid, Relief, and Economic Security (**CARES**) Act, involved increasing the tax relief businesses could claim under the existing net operating loss and excess business loss tax breaks. ***Among other things, the Cares Act made these tax cuts retroactive, meaning businesses can claim losses and reduce their tax liability for years in which the pandemic had no impact on their profitability.***

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Because the Illinois income tax code is predicated on federal law, whenever Congress increases existing tax relief already received by businesses at the federal level, that tax relief automatically applies under Illinois law, resulting in a concomitant reduction in tax revenue for the state. According to State Representative Mike Zalewski, this change in federal law could result in Illinois losing anywhere from $500 million to $1 billion in tax revenue this year, unless Illinois "decouples" from the federal change, as requested by the Pritzker Administration.[27] CTBA's analysis of the potential beneficiaries of the expanded net operating loss and excess business loss tax breaks created under the CARES Act indicates that less than 3% of all business taxpayers in Illinois would qualify to claim them, and includes virtually no small businesses.

For the following reasons, decoupling from the aforesaid federal tax expenditures under the CARES Act would constitute both good tax policy and rational budget policy for Illinois:

(i) The Federal government not only can deficit spend, but should deficit spend to help stimulate economic growth during periods of constrained private sector demand. Illinois, however, is not allowed to deficit spend, and is supposed to introduce a balanced budget annually. Hence, while Congress was acting rationally in context of its responsibilities and budgetary reality, Illinois law makers have the duty to consider whether increasing the tax relief already afforded under the net operating loss and excess business loss provisions makes sense in context of Illinois' state-level responsibilities and budgetary reality.

(ii) Considering that Illinois is already facing an accumulated General Fund deficit ranging between $3.45 billion and $8.45 billion, the loss of an additional $500 million to $1 billion in revenue would require Illinois to cut spending on core services. And making additional cuts to public services covered by the General Fund would be poor public policy, given that, as indicated previously, these services have already been cut by 22.3 percent in real terms over the last two decades, and well over $9 out of every $10 of that service spending covers the core areas of Education, Healthcare, Social Services and Public Safety.

(iii) In fact, making additional cuts to those core services during a pandemic will harm communities across the state in two ways. Not only will those communities lose the public services that are cut—despite the fact that demand therefor is either constant, as in the case of public education, or in some cases increasing due to the pandemic—but their local economies will suffer as well.

(iv) The reason local economies will suffer has everything to do with consumer spending, which accounts for around 67% of all economic activity. When General Fund spending on core services is cut, those cuts are primarily made to the wages of the teachers, social workers, healthcare providers and correctional officers who are on the front line delivering services locally. These public sector workers are middle-income, so they have a high "Marginal Propensities to Consume"—which simply means they spend rather than save most of their income. Similarly, when they lose income due to General Fund spending cuts, they spend less in the local economy. Nobel Prize winning economist Joseph Stiglitz found that this creates a negative economic multiplier that results in private sector job loss.28

(v) Hence, while the federal government is able to continue stimulating the private sector economy despite losing revenue from these CARES Act tax breaks because it can deficit spend, Illinois does not have that luxury. And since the state would have to offset the cost of this tax relief with equivalent spending cuts, Illinois' failure to decouple would reduce demand in local economies statewide.

(vi) Of course, even if Illinois decouples, businesses in the state that otherwise qualify will still receive the increased tax break at the federal level. And it won't be the owners of small businesses who qualify. The expanded net operating loss and excess business loss tax breaks created under the CARES Act can only be claimed by individual business owners who have more than $250,000 in annual income if they are filing singly, or more than $500,000 of annul income

if filing jointly. That is less than 3% of all taxpayers in Illinois and includes virtually no small businesses.

(vii) Five states have already decoupled from these CARES Act tax breaks, including Colorado, Georgia, Hawaii, New York, and North Carolina.29 Colorado, New York, and Hawaii have Democratic governors. Georgia has a Republican governor. North Carolina, which has a Democratic governor, also has a General Assembly controlled by the Republican Party. Hence state governments, with leadership from both parties, are deciding to decouple from the expansion of the net operating loss and excess business loss tax breaks provided under the CARES Act, predicated on their respective state-level situations. Illinois should do the same.

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