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

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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 3 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. 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 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.

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 11 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 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.[21]

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 evaluations 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.