Agenda Item No. 7.0

Chicago Metropolitan Agency for Planning

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MEMORANDUM

To: CMAP Board

Date: November 10, 2009

From: Matt Maloney, Senior Manager-Program and Policy Development

Re: Tax Policy and the *GO TO 2040* Plan

Please find the enclosed summary of a longer report, entitled *State and Local Taxation in the Chicago Metropolitan Area: Existing Conditions and Issues of Significance.* This initial document represents a considerable share of the progress made by CMAP staff in analyzing tax policies and other public finance issues as they relate to the broader context of long range regional planning. The impetus for much of this research is based on the consensus from the April Board workshop that CMAP staff should move forward in studying these issues with the goal of readying recommendations for *GO TO 2040*.

The purpose of this report is to outline the range of key issues related to state and local tax policies across the region, with an emphasis on these major tax types: property tax, sales tax, income tax and motor fuel tax. The report also includes chapters summarizing the available research on taxation and business activity, regional competition and cooperation, and the potential impacts of certain tax policies on land use and development decisions. The report refers to the latter as the "fiscalization of land use", which is a term borrowed from the California experience regarding Proposition 13, property tax caps and the emerging reliance on the sales tax in that state.

On August 19, CMAP convened a collection of local economics and tax specialists to review an earlier draft of this report. We obtained many useful comments, which are incorporated into the current version, and all of the attendees, including economists from the Chicago Federal Reserve Board, the University of Chicago, and the University of Illinois at Chicago, urged CMAP to continue working in this area. The attendees said that they saw CMAP as an agency in a unique position to do high-quality, objective research that could help formulate public policy. Following our presentation, professors from the University of Illinois' Institute of Government and Public Affairs indicated that they would like to work with us in the future and provide service to our region by producing analyses that would complement CMAP's work.

The enclosed report does not contain specific recommendations and should not be viewed as suggestive of any particular policy. However, staff would like *GO TO 2040* to discuss matters of public finance and also provide more direct recommendations about these matters. At this point, staff considers "tax policy" to be one of 10-12 key policy directions for the Plan.

As tax policy contains a host of complex issues, CMAP believes that any recommendations in the Plan should be couched under the broader umbrella of the creation of a **Regional Economic and Fiscal Issues Task Force or Committee, to be housed at CMAP and formed after the adoption of *GO TO 2040***. Membership on this new group would include local government officials, academic experts, business interests, and other civic organizations. Broadly speaking, this group would be charged with coordinating on issues central to the regional economy and sustainability through the lens of state and local fiscal policy. Meetings would help elucidate the direct connections between tax policies and development decisions, further develop staff research in these areas, and provide recommendations.

In specific terms, staff believes that such a group should study, consider and recommend policy action regarding the following issues:

- **The Impact of the Existing State and Local Revenue Sharing Arrangements, with a Specific Focus on the Sales Tax.** Currently, 1% of retail sales within a municipality's borders are disbursed back to the municipality by the State as sales tax revenue. In northeastern Illinois, these disbursements totaled roughly $1.1 billion in 2008. Some evidence suggests that this disbursement arrangement may create an incentive for many local governments to overemphasize retail land use, perhaps at the expense of other uses more beneficial to the regional economy. There is also evidence that the local imperative for this revenue may be one (though not the only) major driver behind local competition and unfocused growth in some parts of the metropolitan area. This suggests re-evaluating the State sales tax disbursement arrangement, in **revenue-neutral** terms that do not reduce local government budgets, and conducting simulations of the effect of policy changes to change the distribution of these tax revenues so that the distribution structure does not create incentives which over-emphasize retail land use over other land uses.

- **Property Tax Classification**. County governments are authorized to assess properties in Illinois. The collar counties assess all properties, regardless of type, at 33 1/3% of market value. Cook County law, on the other hand, stipulates the assessment of residential properties at 10% and commercial properties at 25%. While the ramifications of this arrangement are complex, the main impact is to shift the property tax burden away from residents and toward businesses in Cook. Furthermore, there is good evidence that property tax differentials within metropolitan regions have a significant impact on local business location decisions. With a higher burden placed upon businesses in Cook County due to classification (as well as high sales tax rates), this may have the effect of shifting economic activity out of Cook County in a distortive, rather than a market- driven, fashion. While Cook County has recently reduced its number of classification categories from seven

to two, this is not likely to change the particular burden placed on businesses in Cook County.

- **Property Tax Limitation Law (PTELL)**. In Illinois, increases in property tax extensions for non-home rule municipalities are limited under the Property Tax Extension Limitation Law (PTELL), passed in the early 1990s. PTELL is currently in effect for all northeastern Illinois counties. While designed to limit property tax extensions in areas with rapidly increasing property values, the law has little economic or policy justification, constrains some local government revenues but not others, and may lead local governments toward reliance on less efficient and effective revenue sources, such as the sales tax, to fund government services. In 2009, local governments under PTELL can barely raise extensions at all, given the zero growth in the consumer price index over the last year (PTELL constrains revenue increases based in part on the CPI). PTELL should be re-evaluated, lest Northeastern Illinois undergo the California experience. Potential reforms of PTELL or alternative arrangements should be considered to address the potential problems that arise from property tax caps.

- **State Motor Fuel Tax.** In inflation-adjusted dollars, the State MFT has declined since the early 1990's and the rate has not been raised since. This has negatively impacted State and local ability to address the vital maintenance of the current transportation system against the backdrop of growing deferred maintenance needs. Furthermore, the justification for the complex allocation of state motor fuel tax dollars to local governments and the host of deductions and exemptions should be reevaluated (this should not be read as a suggestion to reduce the allocation to local governments- it is simply to re-evaluate the formulas and deductions). Overall, this suggests that the State Motor Fuel Tax should be raised or new sources of funding for transportation should be identified.

- **Tax Policy and Local Capacity.** While not a recommendation for any specific policy action, this point reflects a strong acknowledgement of the taxation inequities across the region. Several areas within the region have a much greater economic base than others, hence have a greater "tax capacity." While this should be expected to some extent in any metropolitan area, extreme divergences render many local governments helpless in terms of providing essential services and attracting new residents and businesses. Moreover, this divergence is anticipated to grow over time, as municipalities well endowed with strong revenues can keep property tax rates lower while also providing quality services and infrastructure, essential ingredients for attracting and retaining residents and businesses. The impacts of these inequities on school funding should also not be ignored. While education and human capital investments will be covered in a separate recommendation, the purpose of this point is to urge the new task force or committee to address these issues and seek common ground on the policy prescriptions.

ACTION REQUESTED: Discussion

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State and Local Taxation in the Chicago Metropolitan Area: Existing Conditions and Issues of Significance

About this Report

The purpose of this report is to outline the range of key issues related to state and local tax policies across the Chicago metropolitan region, with an emphasis on the property tax, sales tax, income tax and motor fuel tax. The full report also includes chapters and sections summarizing the available research on taxation and business activity, regional competition and cooperation, and the potential impacts of certain tax policies on land use and development decisions. The impetus for much of this research is based on the consensus from the April Board workshop that CMAP staff should move forward in studying these issues with the goal of readying recommendations for *GO TO 2040*.

From a regional planning perspective, it is vital to understand the dynamics of various tax policies, especially in terms of their potential impacts on development decisions and regional economic productivity. Furthermore, most, if not all, planning decisions have fiscal consequences, both direct and indirect. Today's metropolitan landscape is largely shaped by land use decisions made by local governments. In part, these decisions are motivated by localized fiscal imperatives. As the regional agency vested with the task of producing a long range comprehensive plan, CMAP can play a valuable role through researching and analyzing the ramifications of these local decisions as they play out across time and space.

This report does not contain specific recommendations and should not be viewed as suggestive of any particular policy. However, staff would like *GO TO 2040* to discuss matters of public finance and also provide more direct recommendations about these matters. At this point, staff considers "tax policy" to be one of 10-12 key policy directions for the upcoming Plan. Please see the accompanying memo, which reflects more detail on staff's current thinking on what the substance of these recommendations regarding tax policy should be in the Plan.

CMAP's Tax Principles- Adopted by the CMAP Board on May 6, 2009

The following draft principles, adopted by the CMAP Board earlier this year, are intended to help CMAP judge taxes and other revenue generators at the State and local level. While not exhaustive in scope, these principles exist as a helpful starting point for understanding how to think about and analyze components of state and local taxation.

- *Short-term Adequacy and Long Term Sustainability.* In the short term, revenues from taxes and fees should adequately provide for the programs and policies demanded by citizens. Furthermore, over the longer term the bundle of taxes and fees should generate stable and predictable revenues which rise at a level consistent with real changes in purchasing power.

- *Broad Tax Base with Low Tax Rates.* Residents and businesses prefer low taxes, but also good schools and neighborhoods, quality infrastructure, and access to recreational and cultural opportunities. One strategy for keeping tax rates low while also providing for these critical services is to ensure that the tax base as broad as possible. A broad tax base is one with few exemptions, deductions, and credits.

- *Equity.* While equity can be defined in different ways, it is generally agreed that taxes and fees should strive for two different principles. The first, "horizontal equity," means that similar people and firms should share similar burdens. The second, "vertical equity," means that the tax system should be based on the entity's ability to pay. Vertical equity is consistent with a tax system that tends toward the progressive rather than the regressive.

- *Ease of Administration.* A tax or fee that is difficult to collect typically leads to noncompliance. As complexity increases, so does tax avoidance, tax evasion, and the cost of monitoring.

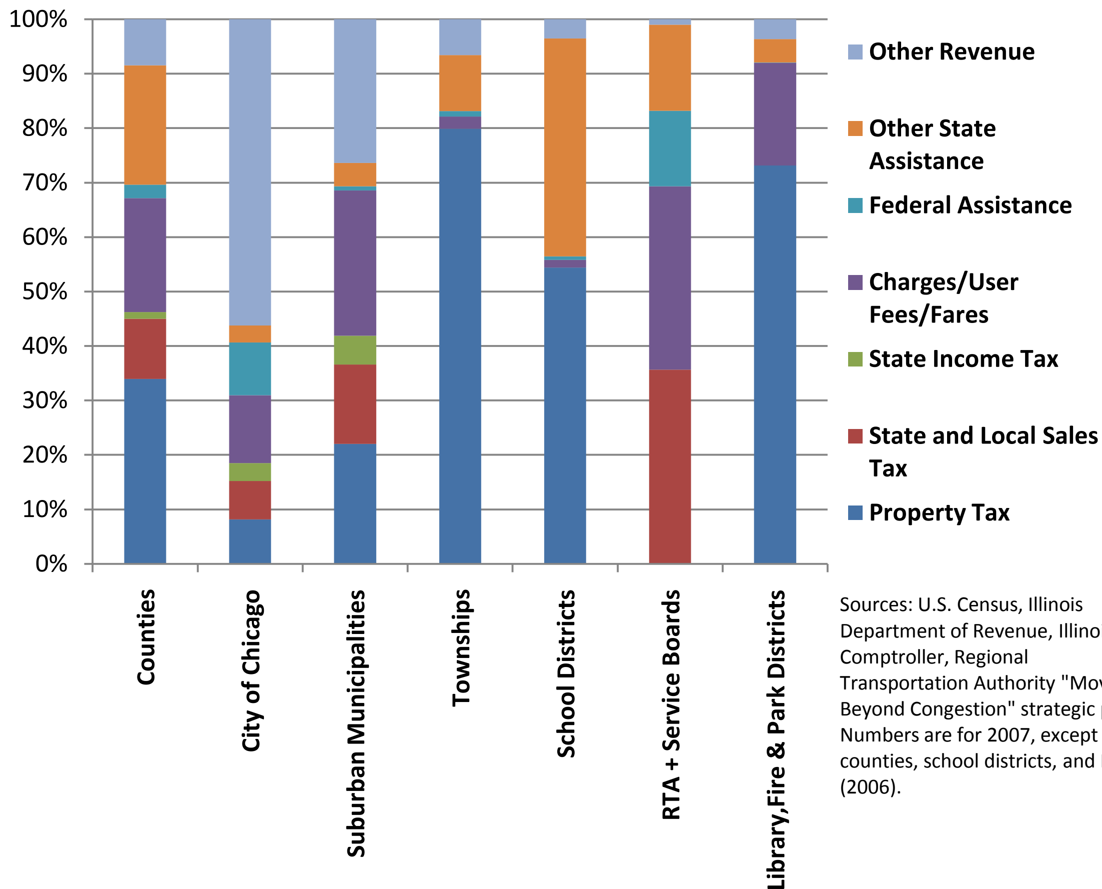
- *Transparency and Accountability.* State and local tax policy should strive to be as open and transparent as possible. It is vital for all taxpayers to have access to a full accounting of the types of revenues collected, the distribution of the revenue, as well as the entities receiving exemptions or other tax benefits.

State and Local Revenues, at a Glance

In the seven-county region of northeastern Illinois, 1,226 different units of government collect revenues and provide services to residents, businesses and visitors. No metropolitan area in the United States has more units of government than Chicago. By CMAP's calculations, units of local government in northeastern Illinois have received nearly $40 billion in annual revenues in recent years[1]. The largest revenue source for local government is the property tax (30%). State intergovernmental revenues including the state sales tax, income tax, motor fuel tax, and other disbursements and aid, make up 20% of the revenue. Charges and user fees make up about 15% of the total.

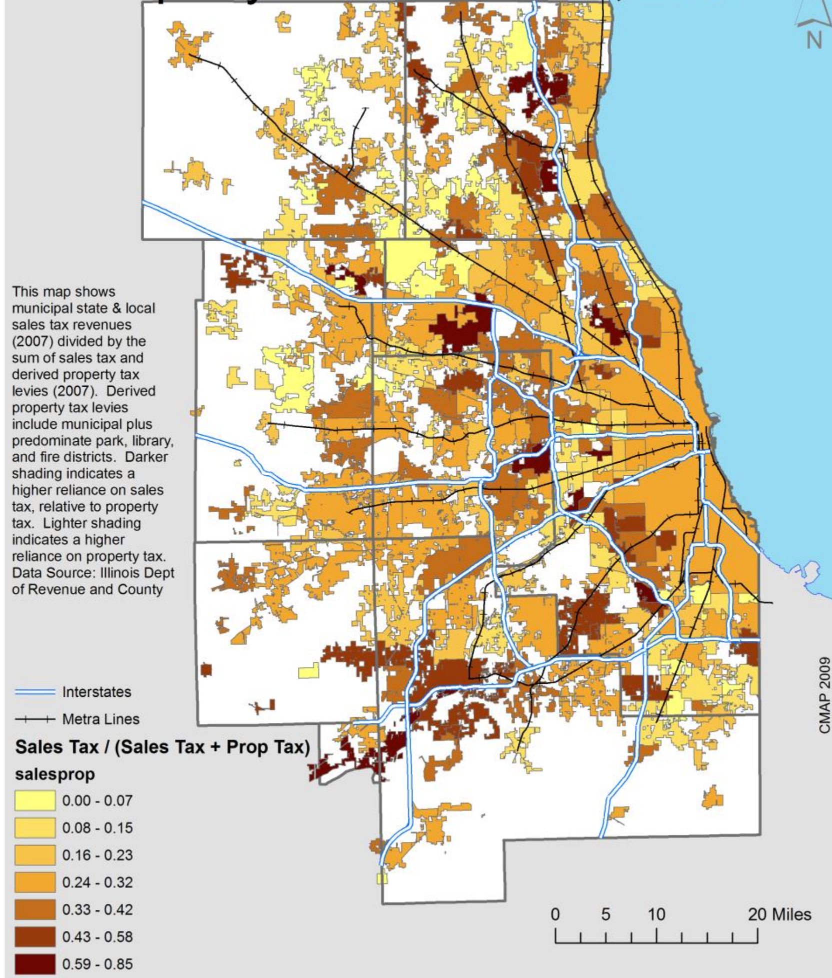
UNITS OF GOVERNMENT IN NE ILLINOIS	
Counties	7
Municipalities	284
Townships	123
School Districts	307
Fire	136
Park	173
Library	108
All Other	88
Total	**1226**

[1] Analysis is based on data from the Illinois Comptroller, Illinois Department of Revenue, and U.S. Census Bureau from the years 2005-2008.



Revenue sources among these local governments vary considerably. The property tax makes up nearly 80% of township revenue, 73% of library, fire, and park district revenue, and 55% of school district revenue. It also remains a very important revenue source for counties (34%) and suburban municipalities (22%). Charges, user fees, and fares also make up a large and growing portion of the budgets for suburban municipalities (27%) and the counties (20%). Farebox revenue for the public transportation system makes up roughly 34% of the total revenues for the Regional Transportation Authority and service boards. The state and local sales tax also remains a large revenue source for the RTA system (36%), suburban municipalities (15%), and the counties (11%). The City of Chicago has a very diverse stream of revenues, owing in large part to a variety of local option taxes, licenses, and fees imposed specifically by the City for various purposes[2].

[2] RTA figures are from Regional Transportation Authority, "Moving Beyond Congestion" report, February 8, 2007.

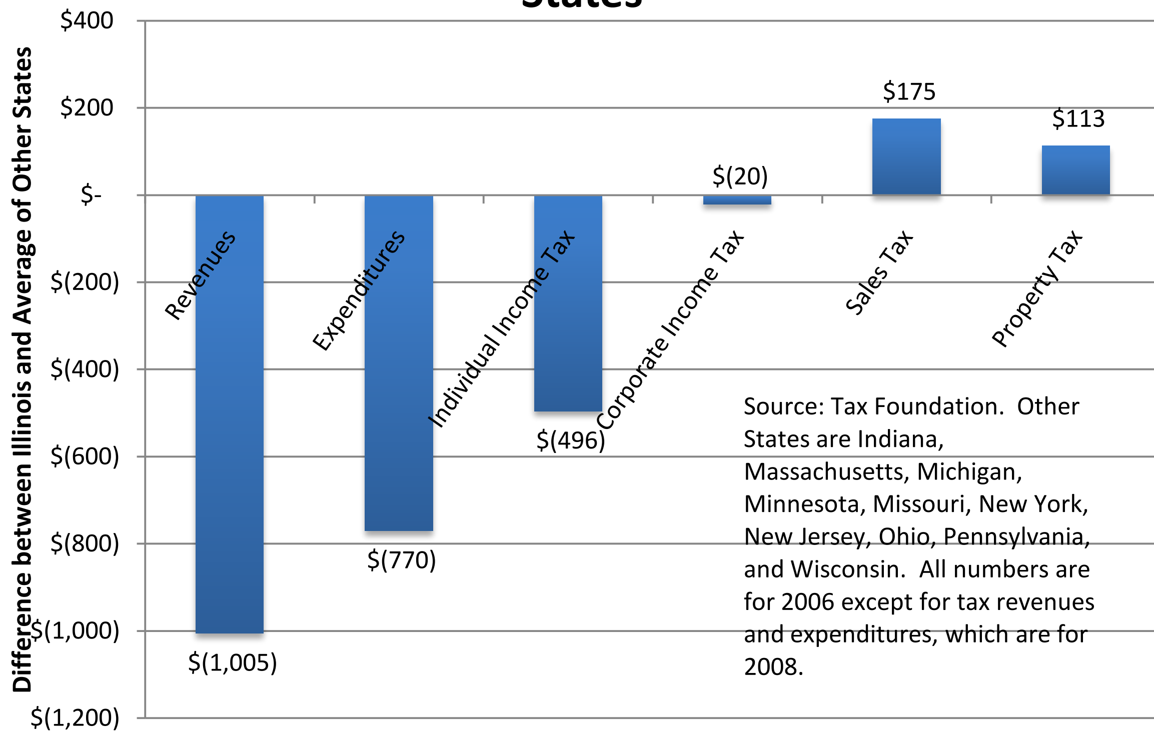


The region's 284 municipalities vary widely in terms of their relative revenue reliance and also in terms of the services they provide. One striking variation is the relative reliance on state and local sales tax revenues, relative to the property tax. Furthermore, while most municipalities provide police, roads, and sewer services, sometimes other units of government provide services like fire, parks, and libraries.

The map to the left shows the relative reliance on sales tax revenues, relative to "derived" property tax levies, which include an estimate of municipal plus predominate park, fire, and library districts. School districts, which rely heavily on property taxes, are not included. The map represents a starting point for understanding the dynamics of reliance on sales tax, relative to property tax, for municipalities and other special districts across the region.

Comparison with Other States

Overall, the State and local governments in Illinois remain more reliant on property and sales taxes and less reliant on personal income taxes than other states. A comparison of tax revenues against ten neighboring and comparable states (Midwestern and Northeastern urban and industrial states: Minnesota, Wisconsin, Missouri, Michigan, Indiana, Ohio, Pennsylvania, New Jersey, New York, and Massachusetts) demonstrates that on a per capita basis, state and local governments in Illinois also generate fewer revenues and make fewer expenditures.



State and Local Revenue Sharing

While all local governments in northeastern Illinois are prohibited from imposing a local income tax, and most cannot impose local option sales taxes, all counties and municipalities receive a share of both back from the Illinois Department of Revenue via a monthly disbursement. Furthermore, other state-sourced tax collections such as the Motor Fuel Tax and Personal Property Replacement Tax return a share of the revenue back to some local governments based on various formulas. In 2007, municipalities in northeastern Illinois received roughly 20% of revenues through state revenue sharing sources.[3] The following table briefly explains some of these state/local revenue sharing arrangements:

[3] Analysis of 2007 Illinois Comptroller data by CMAP.

Examples of State/Local Revenue Sharing Arrangements in the State of Illinois[4]

State Tax Source	How Imposed	Local Governments Receiving Disbursement	Disbursement Formula	Amount Disbursed to Local Governments in Northeastern Illinois (2008)
Sales Tax	6.25 percent state rate for retail sales of general merchandise and 1 percent state rate for sales of qualifying food, drugs, and medical appliances.	Counties, municipalities, and the Regional Transportation Authority[5]	16% of the state collections from retail sales of general merchandise and 100 % of the collections from sales of qualifying food, drugs, and medical appliances are returned to the municipal or county government (if unincorporated) where the sale took place. 4% of the tax collected from general merchandise sales is disbursed to county governments (except Cook County) for sales that occurred anywhere within their county boundaries. For sales made in Cook County, this 4 % share is allocated to the RTA.	$1.9 billion[6]
Personal Property Replacement Tax	Corporations pay 2.5% tax on income, partnerships, trusts, and S-corporations	All taxing units of government[7].	The total collections are divided into two portions. One portion (51.65 percent) goes to Cook County. The other portion (48.35 percent) goes to other counties. The Cook County portion is then distributed to the taxing	$1 billion

[4] Information and language directly from the IL Dept of Revenue was used for this table.

[5] The RTA sales tax rate was increased 0.25% in Cook County and 0.50% in the collar counties effective April 1, 2008. The RTA receives Cook County government's portion of the disbursement share from the State. In addition, the RTA imposes additional rates in Cook County and the collar counties- but these are not part of the disbursement from the base sales tax rate of 6.25%.

[6] This figure does not include home rule/non home rule sales taxes, which are also disbursed (in full) by the IDOR to the municipalities and counties which impose them.

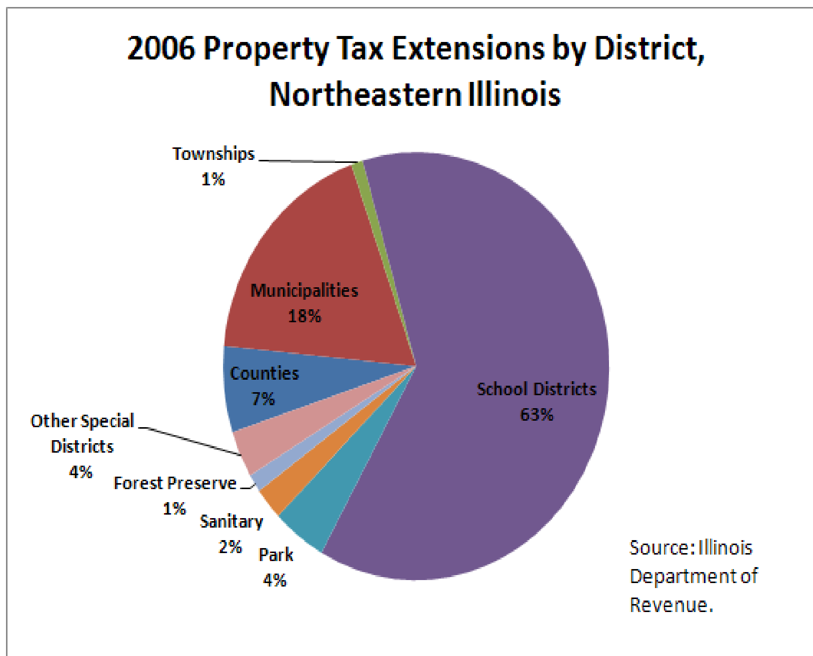
[7] The Personal Property Replacement Tax disbursement formula is extremely complex. See the Illinois Department of Revenue fact-sheet on this issue at http://www.revenue.state.il.us/LocalGovernment/Overview/HowDisbursed/replacement.htm

	pay 1.5% tax on income, and public utilities pay 0.8% tax on invested capital. The PPRT is submitted along with state income tax payments.		districts in Cook County on the basis of each district's share of personal property tax collections for the 1976 year. (For example, if total taxes collected by all districts were $1 million and District A collected $35,000 of that total, District A's share of any future distributions would be 3.5 percent.) The downstate portion is distributed similarly, except that the collections from the 1977 tax year are used to calculate each district's share of the distribution.	
Income Tax	Individuals, trusts, and estates: 3 percent of net income. Corporations: 4.8 percent of net income.	Counties and municipalities	One tenth of total collections minus the amount deposited in the refund fund. The amount that each municipality or county receives is based on its population in proportion to the total state population.	$792 million
Motor Fuel Tax	$0.19/gallon for gasoline and gasohol, $0.215/gallon for diesel and $.215/gallon for combustible gases.	Counties, municipalities, townships.	After a variety of deductions, 54.4% of the balance is allocated to local governments. Of this portion, 49.1% is distributed to municipalities, 16.74% to counties over 1,000,000 in population, 18.27% to counties under 1,000,000 in population, and 15.89% to townships. The municipality's share of the total MFT allocation is based on population. The county share is based on the amount of motor vehicle license fees received. The road district/township share is based on mileage of township roads. MFT funds must be used for transportation purposes[8].	$377 million
Tele-communications Tax	Imposed by local ordinance or resolution in ¼ percent increments with a 6 percent maximum rate limit.	Municipalities	After a ½ percent administrative fee retained by the state treasurer, the Illinois Department of Revenue administers and disburses the full value of the tax revenue collected.	$216 million

[8] Eligible uses can be found in http://www.dot.state.il.us/blr/mftbooklet.pdf

Property Tax

Property tax revenue constitutes the largest source of funding for the counties, municipalities, school districts, and special districts in the Chicago metropolitan area. In Illinois, property tax rates are set by local governments and vary from place to place. Individual taxing bodies, such as counties, municipalities, townships, and school and park districts have their own rates that are individually determined by the relationship between their annual financial requests and the assessed value of property within their geographical boundaries. Property tax rates in the Chicago metropolitan area vary widely. Generally speaking, rates can be understood as a function of service provision needs, the value of real property, and other revenue sources.



Total property tax extensions in northeastern Illinois totaled $17.5 billion in 2006. In 2008 constant dollars, property tax revenues have been on the rise in recent years, increasing from roughly $15 billion in 2000 to over $18 billion in 2006. The distribution of property tax revenues, shown in the chart to the left, skews heavily toward the region's 300+ school districts. In 2006 school districts received 63% of the total extensions in northeastern Illinois. Municipalities received 18%, counties received 7%, and park districts collected 4%. Sanitary districts, forest preserves, and other special districts received a combined 7% of the extensions[9].

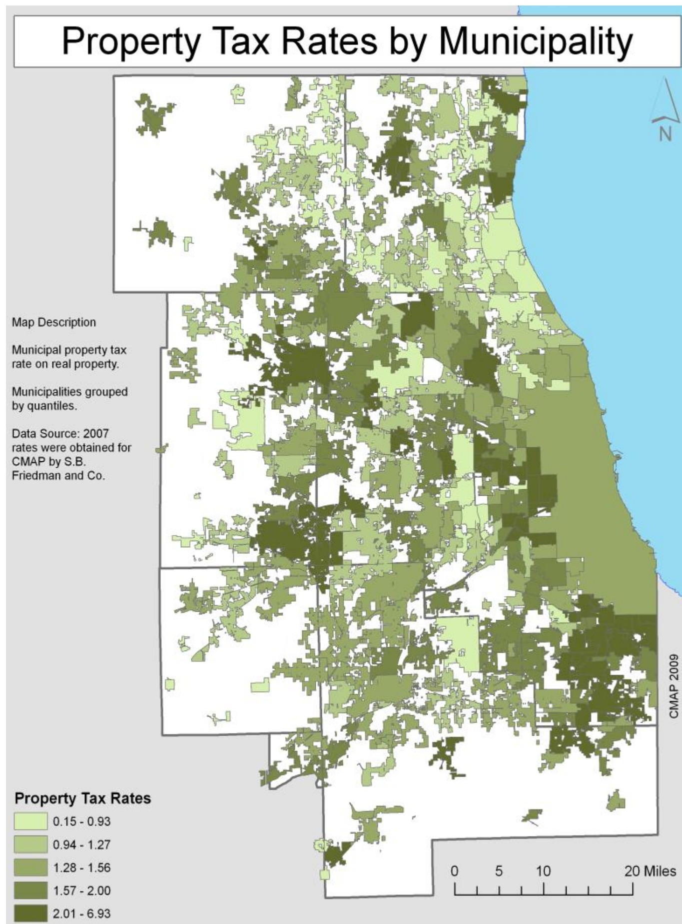
Policy Implications of the Property Tax

- *Property Tax Extension Limitation Law (PTELL).* Increases in property taxes to non-home rule governments are limited by the State of Illinois under the Property Tax Extension Limitation Law (PTELL), passed in the early 1990s. PTELL is currently in effect for all northeastern Illinois counties. The law was designed to limit property tax extensions (i.e. total taxes billed) in areas with rapidly increasing property values, namely locations in which property values were increasing faster than inflation. The law does allow for inflationary increases, which are limited to the lesser of 5% or the increase in the

[9] Illinois Department of Revenue

Consumer Price Index[10]. Recent research indicates that PTELL does indeed limit growth in property tax bills for both municipalities and school districts. Additionally, these results appear to grow stronger over time[11].

PTELL is an important policy issue because the tax cap serves to constrain some local government revenues but not others, which may lead local governments toward reliance on less efficient and effective revenue sources, such as the sales tax, to fund government services. In 2009, local governments under PTELL can barely raise extensions at all, given the zero growth in the consumer price index over the last year (PTELL constrains revenue increases based in part on the CPI). While certainly more extreme than Illinois, the California experience with tax caps under Proposition 13 has led to increased state control over education as well as a greater reliance on zoning and incentives to capture sales tax revenues.[12]



- *Classification.* County governments are authorized to assess properties in Illinois. The collar counties assess all properties, regardless of type, at 33 1/3% of market value (except for agricultural land). Cook County law, on the other hand, stipulates the assessment of residential properties at 10% and commercial properties at 25%. While the ramifications of this arrangement are complex, the main impact is to shift the property tax burden away from residents and toward businesses in Cook. Furthermore, there is good evidence that property tax differentials within metropolitan regions have a significant impact on local business location decisions. With a higher burden placed upon businesses in Cook County due to classification (as well as high sales tax rates), this may have the effect of shifting economic activity out of Cook County in a distortive, rather than a market-driven,

[10] The rate for the 2009 extensions is 0.1%, Illinois Department of Revenue, 1/20/2009.

[11] Dye, R. F., T. J. McGuire, and D. P. McMillen, 2005. Are property tax limitations more binding over time? *National Tax Journal* (58) 215-225.

[12] Chapman, J. I., 1998. Proposition 13: Some Unintended Consequences. *Public Policy Institute of California*.

fashion. The following hypothetical example of two communities shows that while both generate the same amount of tax revenue in both cases ($3,000), classification has the result of placing more of a burden upon commercial properties.

Shifting of Tax Burden Due to Classification - Hypothetical Example of Two Identical Communities- one with 33% Classification for all Properties and one with 10% Residential and 25% Commercial/Industrial Classification

Class of Property	Market Value	Assessed Ratio	Assessed Value	Nominal Tax Rate (Percent)	Tax Revenue	Effective Tax Rate (Percent)	Tax Share (%)
	1	2	3=1*2	4=B/A	5	6=5/1	
Community A: Without Classification							
Residential	$72,000	0.33	$24,000	9	$2160	3	72
Commercial-Industrial	$28,000	0.33	$9,333	9	$840	3	28
Total	$100,000		A=$33,333		B=$3000		
Community B: With Classification							
Residential	$72,000	0.10	$7,200	21	$1521	2.11	50.7
Commercial-Industrial	$28,000	0.25	$7,000	21	$1479	5.28	49.3
Total	$100,000		A=$14,200		B=$3000		

- *School Funding.* Reliance on the property tax for financing education is certainly related to large inequalities among school districts in terms of per pupil spending. For instance, while the national average shows a difference of $825 in per pupil spending between high and low poverty districts, the gap in Illinois is $1,924[13]. While expenditure data is not sufficient for explaining gaps in school and student performance, reliance on the property tax does cause funding inequalities based purely on the differing assessed property values among districts. School districts in Illinois have been demonstrated to be more dependent on the property tax than those in other states. In fact, only Nevada relies more on the property tax for school funding[14]. This situation may obviously

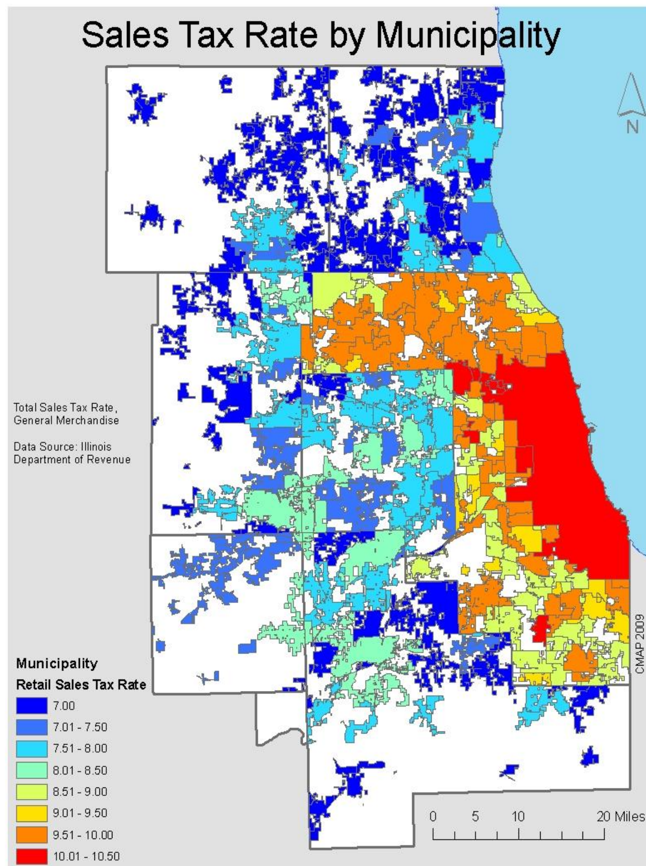
[13] The Education Trust. Funding Gaps 2006. http://www2.edtrust.org/NR/rdonlyres/CDEF9403-5A75-437E-93FF-EBF1174181FB/0/FundingGap2006.pdf

[14] Center for Tax and Budget Accountability. November 2007. Illinois Property Taxes: Issue Brief.

promote funding disparities between areas with high property values and low property values, and may incent local governments to pursue uses with higher property values.

Sales Tax

The various sales taxes imposed across the state raise considerable revenue for the State of Illinois, counties, municipalities, and special districts. In FY 2008, the State of Illinois collected just over one-third of its revenue from the sales tax[15]. The State currently levies the sales tax at a base rate of 6.25 percent on general merchandise and titled or registered items, and 1% on qualifying food, drugs, and medical appliances.



Of the total revenue collected on general merchandise, titled and registered items (the 6.25% rate), the State retains 80 percent of the collections for its own uses and distributes the remaining 20% to local governments (16% to municipalities, 4% to counties), based on point-of-sale[16]. The Cook County portion of this disbursement is allocated to the Regional Transportation Authority, rather than to the county. Of the total revenue collected on qualifying food, drugs and medical appliances (the 1% rate), 100% is returned to the municipality.

Local sales taxes are also imposed by Cook County, municipalities, RTA, and DuPage County Water Commission. The result is a wide variation in sales tax rates faced by consumers across the CMAP region. Rates range from 7.0 percent in Burlington (non-home rule), to 7.5 percent in Lake in the Hills (home rule), to 8.0 percent in Sugar Grove (non-home rule), to 10.25 percent in Chicago (home rule) to 10.5 in Bellwood and East Dundee (home rule).[17]

[15] Illinois Department of Revenue, Annual Report of Collections and Distributions, 2008. Numbers do not include federal intergovernmental revenue and some other program revenues related to charges and user fees.

[16] In unincorporated areas, the county government receives the disbursement that "would have gone" to a municipality.

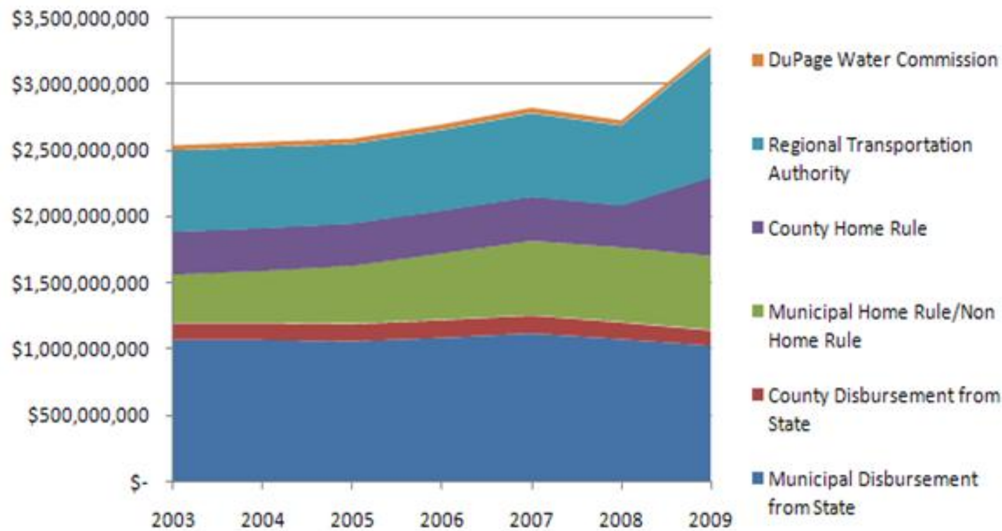
[17] Illinois Department of Revenue, "Illinois Tax Rate Finder," https://www.revenue.state.il.us/app/trii/.

Sales Tax in Northeastern Illinois: Rates and Allocations

Sales Tax	Base Tax Rate	Allocation of Revenues
Retail Sales of General Merchandise, Titled or Registered Items, and Qualifying Food, Drugs, Medical Appliances	6.25%	All revenues are collected by the State and then allocated according to the following formula: 5% state portion (equivalent to 80% of tax collections), 1% municipal portion (equivalent to 16% of tax collections), 0.25% county portion (equivalent to 4% of tax collections). In Cook County, the 0.25% county portion is allocated to the RTA.
Sales of Qualifying Food, Drugs, Medical Appliances	1%	1% (equivalent to 100% of tax collections) is collected by the State and returned to the municipality.
County Option Sales Tax	1.75% in Cook County, .5% in Kendall County.	100% of tax collections is collected by the State and returned to Cook County. The Kendall County local option tax is used for transportation.
Municipal Home-Rule/Non-Home Rule Local Option Sales Tax	Rates apply to general merchandise and vary widely across the region.	100% of tax collections are collected by the State and returned to the municipality.
RTA Sales Tax	In Cook County: 1% on general merchandise and titled/registered items, and 1.25% on food, drugs and medical appliances. In DuPage, Kane, Lake, McHenry, and Will: 0.75% on general merchandise, titled or registered items, and qualifying food, drugs and medical appliances.	Cook County portion: 100% of tax collections are collected by the State and disbursed to the RTA. Collar county portion: 0.50% (equivalent to two-thirds of tax collections) is collected by the State and disbursed to the RTA. 0.25% (equivalent to one-third of tax collection) is collected by the State and disbursed to the county governments.
DuPage County Water Commission	0.25% above and beyond state and local rates on general merchandise and titled and registered items in unincorporated DuPage County and municipalities served by the district.	100% of tax collections are collected by the State and returned to the DCWC.

Over the last seven years, total sales tax revenues retained by local governments in northeastern Illinois have risen. In 2009, local governments, including the RTA, received over $3 billion in

sales tax, representing an over $500 million dollar increase from 2003 (in 2008 constant dollars). However it is important to note that this rise has been driven primarily by recent rate increases to county local option sales tax rates and to the RTA sales tax. Municipal and county disbursements from the State have actually fallen in constant dollars between the years 2003 and 2009.



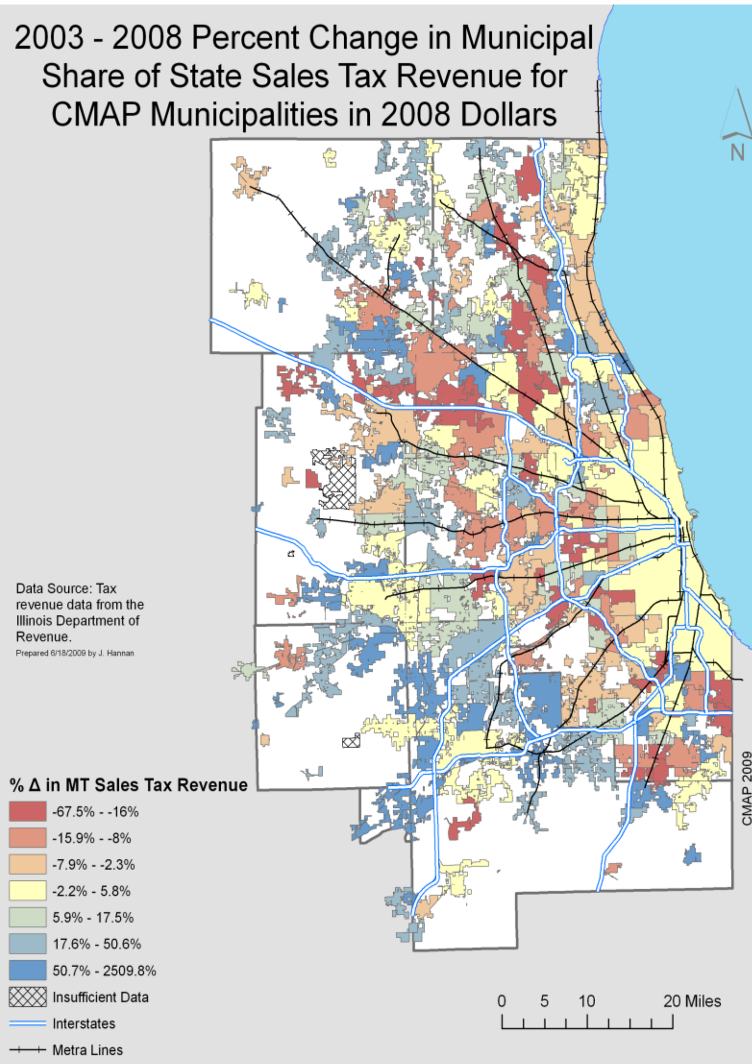
Source: Illinois Department Revenue, Monthly Disbursement Reports

Policy Implications of the Sales Tax

- *High Rates.* Sales tax rates in Northeastern Illinois currently are among the highest in the U.S., and include the highest major city sales tax rate in the nation (Chicago, 10.25%). While the State has a base rate for sales taxes comparable with other states in the region, the range of allowable local rates in Illinois is higher than any neighboring state except Missouri. This issue has recently gained political focus in the Chicago region due to the March 2008 decision to increase Cook County's sales tax by one percentage point, to 1.75 percent. This move follows the January 2008 sales tax increase that was a key part of the Regional Transportation Authority's funding reform.[18] That plan raised sales tax by 0.25 percent in Cook County and 0.5 percent in the collar counties, a portion of the proceeds of which go into the RTA's operating budget. Because of these recent additions to already high rates, there may be limited additional capacity in sales tax.

[18] Regional Transportation Authority, *2009 RTA Budget*, 7

- *Regressivity.* Despite its application in all but five of the fifty states, the sales tax has been criticized as being regressive, i.e. that it disproportionately affects the poor. According to the Institute on Taxation and Economic Policy (ITEP), the poorest quintile of Illinois residents paid just under 12 percent of their income in state and local taxes in 2007; nearly 7 percent of these residents' incomes were paid in sales tax alone. On the other hand, the top one percent of Illinois residents paid just under 5 percent of their incomes in state and local taxes during the same period, with sales taxes claiming less than 1 percent. [19] The fact that tangible goods are taxed but services are not further exacerbates the sales tax's unequal impact; the poor are less likely to buy services compared to the wealthy.



- *"Fiscalization of Land Use".* The reliance of municipalities on sales tax revenue may have particularly important implications for local development decisions. Recent research has proposed several important policy questions related to this issue. The efforts of multiple communities to capture the fiscal benefits of new retail developments may result in the over-provision of this land use relative to others in an attempt to capture retail spending dollars. These development policies may produce a net regional fiscal cost if incentive outlays are used to attract the business from one community in the region to another. Furthermore, there is evidence that a heavy reliance on sales tax revenues may not be sustainable over time, given fluctuations in the economy that greatly impact retail sales.

[19] Institute on Taxation and Economic Policy (ITEP), "Ready, Set Reform", May 2009.

State Income Tax

The Illinois Constitution allows for a fixed rate, or "flat," tax on personal and corporate incomes. Different flat rates are assigned to corporations, individuals, and trusts and estates. The rate levied on corporations is not to exceed that levied on individuals according to an 8 to 5 ratio. For individuals, the rate is 3% of net income. The rate for corporations is 4.8% and the rate for trusts and estates is 3%. The gross income tax is collected by the Illinois Department of Revenue and deposited by formula into four separate funds. One tenth of the General Revenue Fund collection is then disbursed to counties and municipalities, based on population. In FY 2008, $1.2 billion in income tax revenue was disbursed to counties and municipalities. Local governments in northeastern Illinois received about 60% of this amount, or roughly $713 billion in revenue.

Policy Implications of the State Income Tax

- *Flat Nature of the Tax.* While the tax is slightly progressive, the State of Illinois version remains one of if not the least fair income taxes in the U.S. According to the Institute on Taxation and Economic Policy, low-income residents in Illinois still pay more (and high-income residents pay less) of their income in state income tax than so other state residents[20]. The main reason is that few states use a flat rate like the one in place in Illinois. Most opt instead for a graduated system. In fact, of the 40 states that collect income taxes, Illinois is one of only seven that charges a flat rate, as opposed to a graduated system. A graduated system could expand tax capacity with marginal rates for different brackets based on ability to pay. Graduated taxes are typically considered to be progressive in nature and thus more equitable, although the increased complexity of the tax complicates its administration.

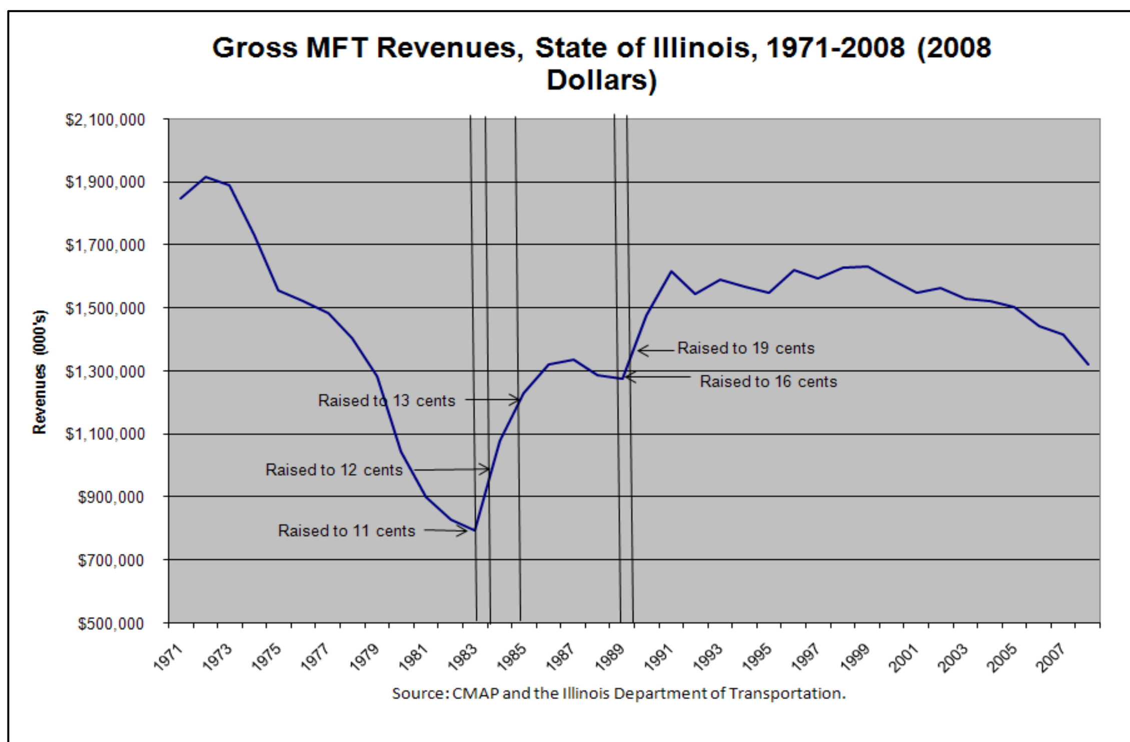
- *The 8 to 5 Ratio.* The untapped tax capacity of the state income tax is significantly restricted by the Illinois Constitution, which stipulates the 8:5 ratio of corporate to individual income tax rates. While increasing the flat tax rate can be accomplished without a Constitutional amendment, the 8:5 ratio must continue to hold. Constitutional amendments (the process for which is described in Article XIV of the Constitution[21]) could abolish the 8:5 ratio, allow home rule and other local governments to administer an income tax, or potentially reorganize the entire state income tax.

[20] Institute on Taxation and Economic Policy. *Ready, Set Reform: How the Income Tax Can Help Make the Illinois Tax System Fairer and More Sustainable*. May 2009.

[21] Constitution of the State of Illinois, Article XIV – "Constitutional Revision", December 15, 1970. Accessed from http://www.ilga.gov/commission/lrb/conmain.htm

State Motor Fuel Tax

The Motor Fuel Tax (MFT) raises considerable revenue for both the State of Illinois and local governments, and the distribution of these revenues is the primary state-generated source of funding for road maintenance and construction. In inflation-adjusted dollars, the MFT has declined since the early 1990's. After a variety of deductions, 45.6% of the revenues allocate to the Illinois Department of Transportation's Road Fund and State Construction Fund, and the remaining 54.4% is allocated to local governments[22]. In 2008, roughly $200M was deducted off the top for various programs and funds, $341M was distributed the IDOT Road Fund, $200M to the IDOT Construction Fund, and nearly $600M was allocated to local governments.



Policy Implications of the State Motor Fuel Tax

Revenues are not Keeping Pace with Inflation. It is likely that a large untapped revenue capacity exists in the State MFT, based on the fact that the 19-cent per gallon rate has not been raised since 1990. Inflation-adjusted revenues from the State MFT have declined since 1991 at a median annual rate of nearly 1.5%. Additionally, 31 states levy a higher per gallon tax rate than Illinois[23]. It is important to note that the decline in these funds occurs against a backdrop of

[22] Illinois Department of Transportation. Bureau of Local Roads and Streets Manual. January 2006. Chapter 4: "Local Roads and Streets Funding".

[23] Federation of Tax Administrators, "Motor Fuel Excise Tax Rates", January 1, 2008. http://www.taxadmin.org/fta/rate/motor_fl.html

increasing deferred maintenance needs for the State and local governments, due primarily to the increased costs to maintain or reconstruct roads and bridges. While these MFT allocations have decreased close to 30% (in real terms) between the years 1996 and 2008, maintenance costs on local roads have grown steadily over this time[24]. The result is a tremendous drop in MFT purchasing power for local governments who seek to maintain their roads in a state of good repair.

Taxation and Land Use

While local governments in the Chicago metropolitan region rely on a variety of different taxes for some portion of their municipal revenue, the most prevalent sources are the sales and property tax. Reliance on (or the drive for) one or both of the revenue sources may have regional land use implications. The local fiscal imperative may be to orient land use planning and decision-making to maximize these revenue streams.

Orienting land use decisions to maximize municipal revenue streams became widely recognized as an issue in California following the adoption of Proposition 13 (which limited property tax increases). This behavior has been dubbed the "fiscalization of land use", which can be defined as a local land-use decision process whereby municipalities choose retail and other industries that generate local tax revenues, rather than industrial or office uses that generate jobs. High tax-generating uses such as big-box retail and auto dealerships tend to create more dispersed land use patterns, as demonstrated by their low floor area ratio (FAR), higher reliance on surface parking, and automobile orientation. This creates a conflict between local decisions to maintain fiscal balance and the regional economic goal to preserve and create full-

Table 4: Fiscal and Economic Impact Comparison by Acre

	Retail Power Center	Auto Dealership	Corporate Office	Industrial
Fiscal Impacts				
Fiscal Revenues / Acre	$62,200 - $85,600	$92,733 - $111,400	$23,533 - $68,433	$4,500 - $6,733
Fiscal Expenses / Acre	$ 9,900	$ 3,867	$ 22,500	$ 3,533
Net Fiscal Impact / Acre	$ 52,300 - $ 75,700	$ 88,867 - $ 107,533	$ 1,033 - $ 45,933	$ 967 - $ 3,200
Direct Economic Impacts				
Direct FTE Jobs / Acre	15.9	7.1	60.8	10.7
Direct Wages / Acre	$573,119	$452,928	$6,873,734	$813,993
Indirect Economic Impacts				
Indirect FTE Jobs / Acre	5,978	4,216	80,194	16,916
Indirect Wages / Acre	$334,747	$231,861	$4,490,875	$1,065,682
Total Regional Output / Acre	$2,649,467	$1,736,600	$31,165,033	$7,892,400

Sources: Minnesota IMPLAN Group, Bureau of Labor Statistics, and *S. B. Friedman & Company*.

[24] Parsons Brinckerhoff, Economic Forecasting Review. Volume 3, Issue 1. May 2009. Since 2001 especially, the construction cost index has outpaced the consumer price index.

time jobs, generate compact land use patterns, and further an efficient urban transportation framework.

S. B. Friedman & Company was engaged by CMAP to quantify the municipal fiscal benefits and regional economic benefits for four different land uses in order to demonstrate these conflicts using data and metrics specific to the Chicago region. The land uses investigated were: auto dealership, retail power center, corporate office, and light industrial. The selection of land uses were such that each would result in large-scale development with significant development impacts, providing an opportunity to highlight the fiscal and economic disparities associated with current tax policies. The analysis also focuses on suburban Chicago, where greenfield land is more readily available for such large-scale developments and where such development is occurring at a relatively rapid pace.

The results indicate a significant difference between the "high-sales-tax-generating" retail and auto uses versus the office and industrial uses. While a retail power center and an auto dealership cluster are estimated to generate significantly more tax dollars at the municipal level, they generate jobs with lower salaries and have several orders of magnitude less output than the office and industrial options. These results highlight the potential for disparity between local land use decisions and regional planning for jobs and industry.

Taxation and Business Attraction/Retention

The question of how tax policies impact state and local economic activity has been researched extensively. While conclusions vary, this research does inform how to think about these issues. Two of the main conclusions are as follows:

- *While state and local taxes do have an impact on business location decisions, the impacts appear to be relatively small relative to other factors.*

As firms seek to maximize profits, it follows that higher tax rates (which reduce business revenue) should negatively impact where businesses choose to locate. However, while this statement may be true "all else equal", this assumption does not necessarily reflect the reality on the ground. Tax rates are only one of many characteristics driving these decisions. Other factors, including labor force quality, infrastructure, and the regulatory environment may assume more importance for businesses. Furthermore, taxes are usually linked to the provision of services and amenities. While it is true that extremely disadvantaged areas must often keep tax rates high simply to keep pace with service needs, in many cases increased tax revenue can be associated with higher quality services. For example, a business may be willing to pay higher property taxes in one municipality if the result is higher quality policing, which in turn allows the business to forgo the hiring of private security.

- *Tax differences appear to have a larger impact on business activity within metropolitan regions rather than across them.*

While the effect of taxes appears to be small relative to other factors, there is good evidence that taxes matter more within metropolitan areas rather than across them. While "state vs state" or "region vs region" tax differentials show only small impacts in terms of business attraction and retention, the "local vs local" differentials show relatively larger impacts. These results lend credence to the theory that local governments comprise a type of "marketplace", where municipalities and counties compete with one another to attract and retain businesses to enhance local tax bases. This may set the stage for a competitive environment over tax revenues, and thus development, within the metropolitan area, and many businesses that can move relatively cheaply within the metropolitan region will do so in order to take advantage of these differentials.

Next Steps

While this report provides an overview of the region's state and local tax system and relevant policy issues, it does not make specific recommendations for action. This report is designed to inform CMAP's approach to the *GO TO 2040* plan, which will make such recommendations.

CMAP will continue to engage in a variety of data collection and analysis efforts related to state and local taxation. Some of these continuing efforts are as follows:

- Regression analyses to estimate the main taxation and socioeconomic drivers behind retail land uses, property tax rates, and other dependent variables.
- Continued research and analysis on both "horizontal" and "vertical" tax competition. "Horizontal" tax competition refers to competitive efforts among the same units of government (i.e. municipalities) over tax revenues. "Vertical" tax competition refers to competitive efforts among different units of government (i.e. counties and municipalities).
- Outreach efforts to county and municipal governments to gain a better understanding of local issues and concerns related to state and local taxation.
- Continued research on government services and expenditures as well as relevant policy issues.