DRAFT CMAP Regional Tax Policy Principles

Tax policy plays a key role in influencing local development decisions, infrastructure investments, and the overall regional economy. In 2011, the Chicago Metropolitan Agency for Planning (CMAP) convened a Regional Tax Policy Task Force that made recommendations to the CMAP Board on tax policy issues affecting northeastern Illinois. A major recommendation of the task force was that CMAP should play a leadership role in developing sound tax policy principles that help to implement GO TO 2040's goals for regional prosperity.

CMAP believes that the discussion around the upcoming expiration of the 2011 income tax rate increase may create an opportunity for comprehensive tax policy reform, and the agency's regional perspective could play an important role in helping to guide these reforms. Staff recommends that the Board approve three principles derived from GO TO 2040 to guide CMAP's perspective on state and regional tax policy:

Principle 1: **Sustainable economic prosperity requires an efficient and equitable tax system.** CMAP supports expansion of the state sales and income tax bases, a lowering of the state sales tax rate, and an adjustment of the individual income tax rate. These major reforms could keep revenues level while improving efficiency, equity, and the overall state and regional business climate.

Principle 2: **Capital infrastructure modernization requires robust, consistent investment**. CMAP supports increasing the state motor fuel tax rate and implementing a long-term replacement. CMAP also supports a new state capital program for infrastructure, but only if coupled with reform, including the implementation of performance-based funding to drive more effective and accountable transportation investments.

Principle 3: **Achieving livability requires a tax structure that does not discourage the implementation of community planning goals.** CMAP supports reforming the state sales tax revenue sharing system to integrate new criteria for disbursing *incremental growth* in revenue so development is driven by broader planning and development goals, rather than the structure of the tax system. CMAP also supports phasing out property tax classification in Cook County to create more opportunities for redevelopment.

Principle 1. Sustainable economic prosperity requires an efficient and equitable tax system.

Illinois' sales and income tax bases are relatively narrow, because Illinois exempts certain types of sales and income. Broadening the tax base to include more services and retirement income would improve revenue stability, help revenues keep pace with broader economic trends, and improve tax burden equity across similar businesses and residents. Moreover, a broader tax base also allows for lower tax rates, which can improve the state and regional business climate. CMAP supports reforms that address these inefficiencies and inequities in our tax structure.

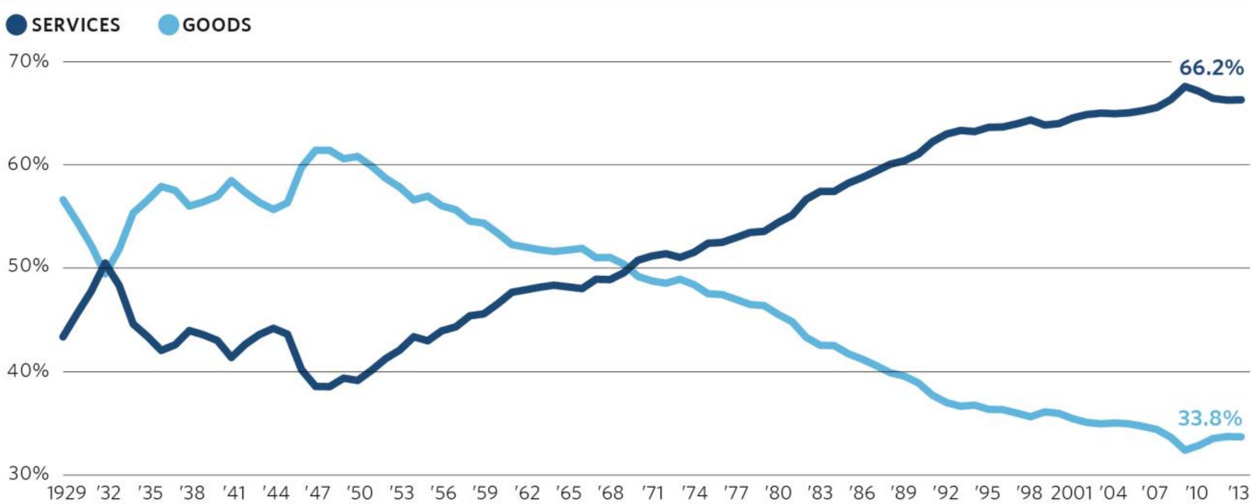
The reforms discussed in this section are necessary to ensure the state's and region's continued economic prosperity.

CMAP supports expanding the sales tax base in conjunction with lowering tax rates.
Illinois' sales tax base covers tangible goods but only 17 services, while sales tax rates are often set very high (10 percent in some local jurisdictions.) CMAP supports broadening the sales tax base to include additional services and lowering sales tax rates.

Based on analysis compiled by the the Illinois Department of Revenue (IDOR), CMAP estimates that approximately $2 billion would be added to the base statewide if the sales tax base were expanded to include a selection of 63 additional services that are most commonly included in other states' tax bases or that were specified in previous state legislation to expand the tax base. Professional services such as medical, legal, engineering, architecture, advertising, and adminstrative services are not assumed in this estimate. The region's business climate would also be improved by a lower state sales tax rate in conjunction with an expanded base.

Broadening the sales tax base would improve revenue stability and help revenues keep pace with growth in the economy. This is because the service sector of the economy accounts for a much larger proportion of both consumer spending and production than it did 80 years ago, when sales tax policies were institutionalized. The graph below displays the growing disparity between personal consumption expenditures on goods and services in the U.S. since 1929.

U.S. personal consumption expenditures, 1929-2013, proportion of total personal consumption



Source: U.S. Bureau of Economic Analysis, April 2011

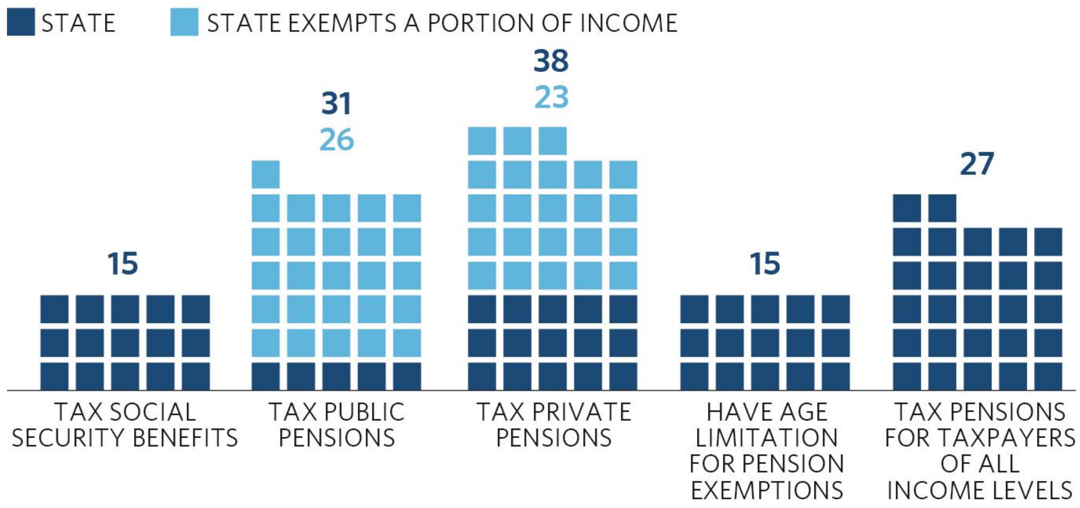
Nationally, consumption of services has grown faster than goods over the past 84 years.

CMAP supports broadening the state individual income tax (IIT) base in conjunction with adjusting tax rates.
At 5 percent, Illinois individual income tax rates are now similar to those of neighboring states. However, the rate is set to drop to 3.75 percent in 2015, in accordance with the temporary rate increase implemented in 2011. At the same time, the overall tax base remains narrow due in part to its exemption of retirement income. CMAP supports broadening the state individual

income tax (IIT) base to include the same categories of retirement income as the federal government, which includes social security under certain income criteria, qualified pension plans, IRA's, and deferred compensation plans. CMAP also supports adjusting tax rates in conjunction with expanding the tax base, by either lowering the tax rate or implementing a graduated rate structure to reduce the tax burden on those least able to pay.

While the federal government includes a portion of retirement income in its income tax base, Illinois is one of three states to exclude all retirement income from its individual income tax. Expanding the state income tax base to include retirement income over a specific threshold would provide a tax base that remains stable even as the state's demographics change.

Tax treatment of retirement income among states, 2006



Source: AARP Public Policy Institute, "State Taxation of Social Security and Pensions in 2006."

The 41 states with an individual income tax take variable approaches to including retirement income in their income tax base. Only three exclude all retirement income.

In 2012, the Illinois tax deduction for retirement and Social Security income was equivalent to 12.7 percent of the total revenue generated from the individual income tax. At nearly $2.0 billion, this was the largest tax deduction or exemption in Illinois.

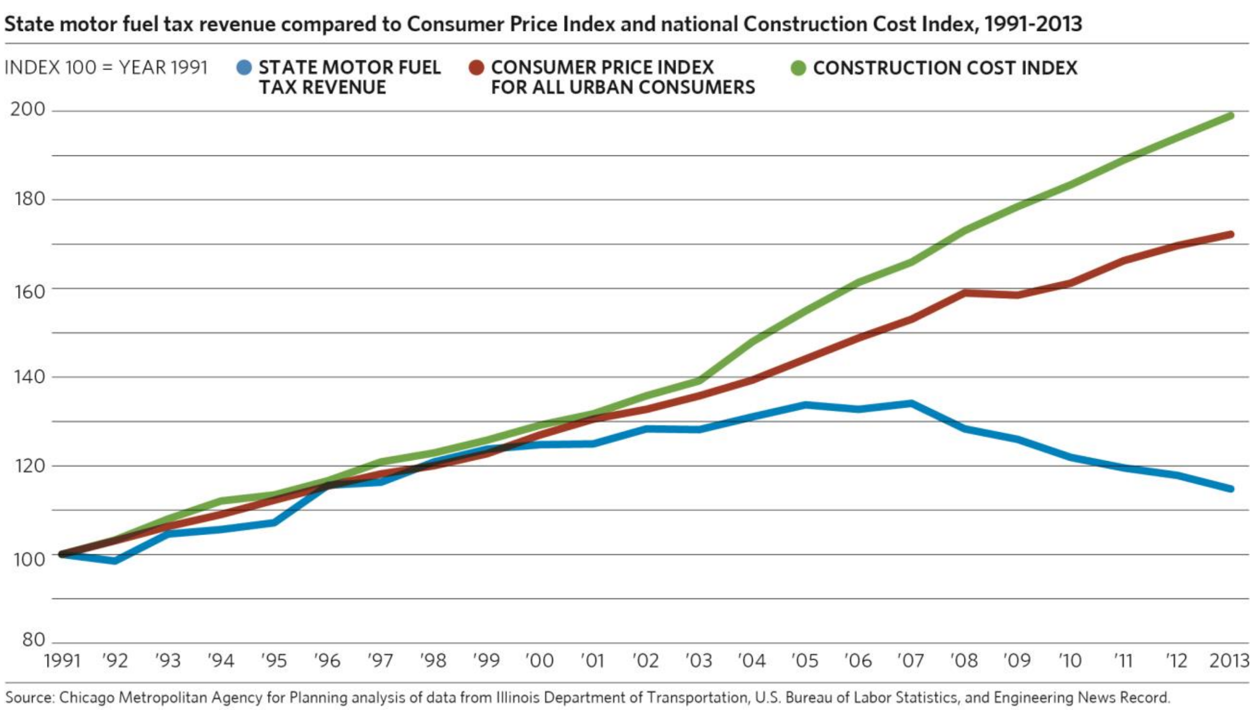
Broadening the base would provide an opportunity to adjust rates by either lowering the overall rate or implementing graduated income tax rates, which would require an amendment to the state constitution. Among the 41 states that impose income taxes, Illinois is one of only seven that imposes a flat rate on taxpayers of all income levels. The remaining 34 states impose graduated rates that increase as taxpayers' income levels rise. Under a graduated tax system, the tax rate for a particular income range or bracket only applies to income that falls within the bracket. Under graduated rather than flat rates, vertical equity is improved because tax burdens reflect taxpayers' ability to pay.

Principle 2. Capital infrastructure modernization requires robust, consistent investment.

The traditional state revenue source for transportation -- the motor fuel tax -- has lost significant purchasing power over the last 20 years, jeopardizing the safe and adequate maintenance of our infrastructure. In addition, state capital programs for infrastructure remain episodic and insufficiently funded. In order to maintain and modernize our transportation system, we need more robust and consistent investment. Given this lack of stable funding, the continuation of the arbitrary "55/45 split" that directs only 45 percent of federal and state highway funds to the Chicago region, and the lack of transparent project selection, CMAP believes that any new state capital program must be coupled with reform.

CMAP supports increasing the state motor fuel tax rate and implementing a long-term replacement.

GO TO 2040 recommends that the state motor fuel tax (MFT) be increased by 8 cents and indexed to an inflationary measure. Since it is a per gallon tax, the state MFT revenues have failed to keep pace with construction costs and has remained at $0.19 per gallon since 1991. In addition, state MFT revenues have been declining annually since 2007. Revenues have declined partially as a result of a reduction in vehicle miles traveled. However, the consumption of motor fuel has declined even faster than vehicle miles traveled, primarily as a result of rising vehicle fuel economy that will increasingly be driven by increasing federal Corporate Average Fuel Economy (CAFE) standards. The following chart compares growth in state MFT revenue with growth in construction cost and inflation.



As a per-gallon tax, MFT revenues have failed to keep pace with inflation in construction costs over time. For this analysis, the consumer price index for all urban consumers is used for inflation, while the Engineering News Records' national construction cost index is used to measure construction costs.

As motor fuel consumption continues to slow and vehicle fuel economy rises, raising the MFT rate will be insufficient to keep revenues growing with the cost of construction in the long run. CMAP recommends replacing the MFT with a more sustainable source of funding. Replacements currently being considered in Illinois and elsewhere across the U.S. include a fee on vehicle miles traveled, a sales tax on wholesale motor fuel, and tolling a greater portion of the existing interstate system.

CMAP supports coupling a new state transportation capital program with reforms.

In recent months, transportation and business leaders across Illinois have begun the conversation about a potential new capital program. Making investments in the region's transportation system will necessitate future policy changes to bring additional revenues to the region. CMAP believes that any new state capital program must be coupled with reform. Furthermore, not all new revenues should be used for debt service -- some of the new revenue should have a "pay-as-you-go" element to stabilize the state road fund to pay for ongoing needs.

CMAP supports a new state capital program that: 1) is funded through new user-fee generated revenues, 2) moves away from the 55/45 split and toward a performance-based funding system, and 3) provides additional capital funding for both highways and transit.

Principle 3. Achieving livability requires a tax structure that does not discourage the implementation of community planning goals.

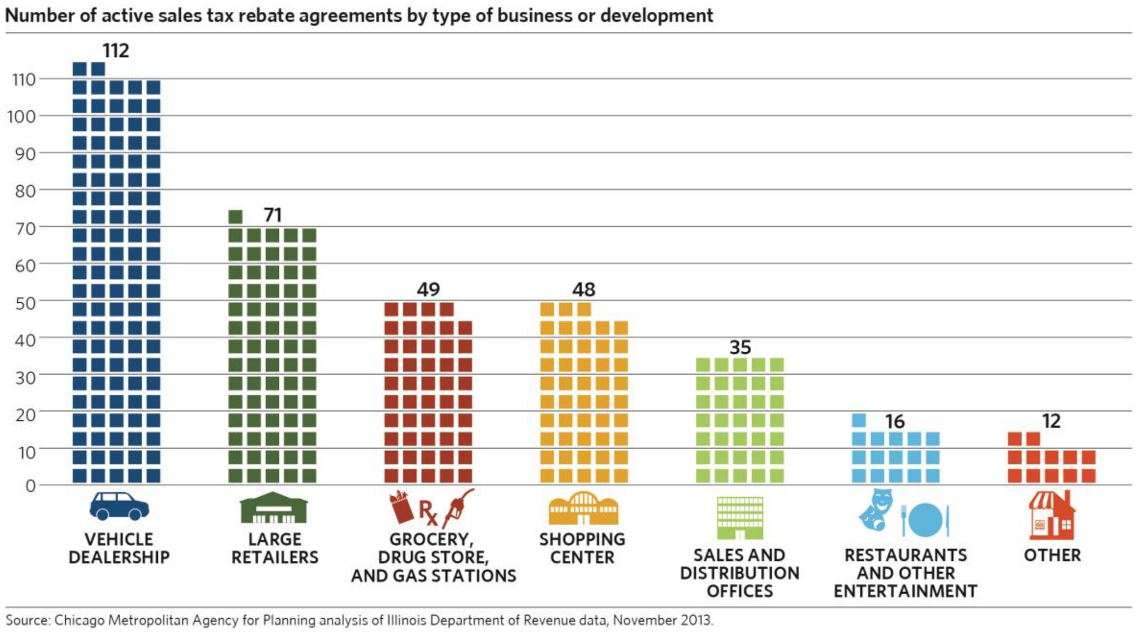
Tax policy should support GO TO 2040's livability goals by encouraging local decisions that make effective use of land and trigger sustainable economic activity. The tax structure itself should not create the overriding motivation to favor one type of development over another. The current system often places development decisions at odds with local plans, and can create serious regional divergences across local tax bases and rates.

CMAP supports reforming the sales tax revenue sharing system to integrate new criteria for disbursing incremental growth in revenue.

State statute provides that local governments receive state sales tax revenues based on local point of sale. In practice, this policy can foster a preponderance of attention on large retail developments and encourage intense local competition. One outgrowth of our sales tax policies is local governments' use of sales tax rebates to attract or retain these developments. Sales tax rebates are the most common incentive offered by local governments throughout the region to encourage sales-tax generating development; there are currently 343 active sales tax rebate agreements in more than 130 local governments. CMAP's analysis of these agreements reveals the sales tax rebates offered in our region by business type, as summarized in the chart below.

While sales tax rebates remain popular local tools for driving development decisions, CMAP's analysis has also shown that because these incentives, which are driven by the statutory criteria for sales tax revenue sharing, rarely attract net new economic activity to the region, they result in limited overall economic benefit.

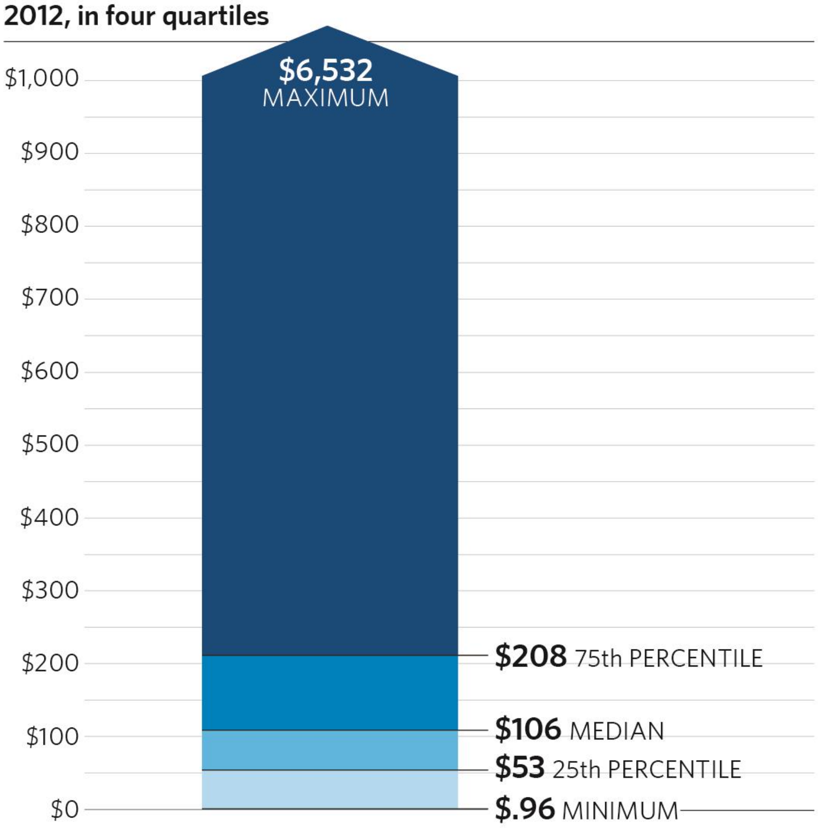
CMAP supports reforming the state sales tax revenue sharing system, with a focus on new or incremental revenues, to encourage a more direct relationship between tax revenues and broader goals for planning and development.



Using information downloaded from the IDOR sales tax rebate database, CMAP classified agreements into business and development categories. While nearly a third of the active sales tax rebate agreements in the region are for vehicle dealerships, almost half are for retail categories.

Illinois' method of distributing sales tax revenue also contributes to some [extreme divergences] in local tax base around the region, which can stifle the competitiveness of the overall metropolitan region. Communities with an extremely low tax base must hike property tax rates to meet levies, further discouraging redevelopment efforts. The chart below illustrates the range of state sales tax revenue disbursements across municipalities in the CMAP region.

Per capita sales tax revenue in Chicago region by municipality, 2012, in four quartiles



Source: CMAP analysis of Illinois Department of Revenue data;
U.S. Census Bureau, 2010 decennial census data.

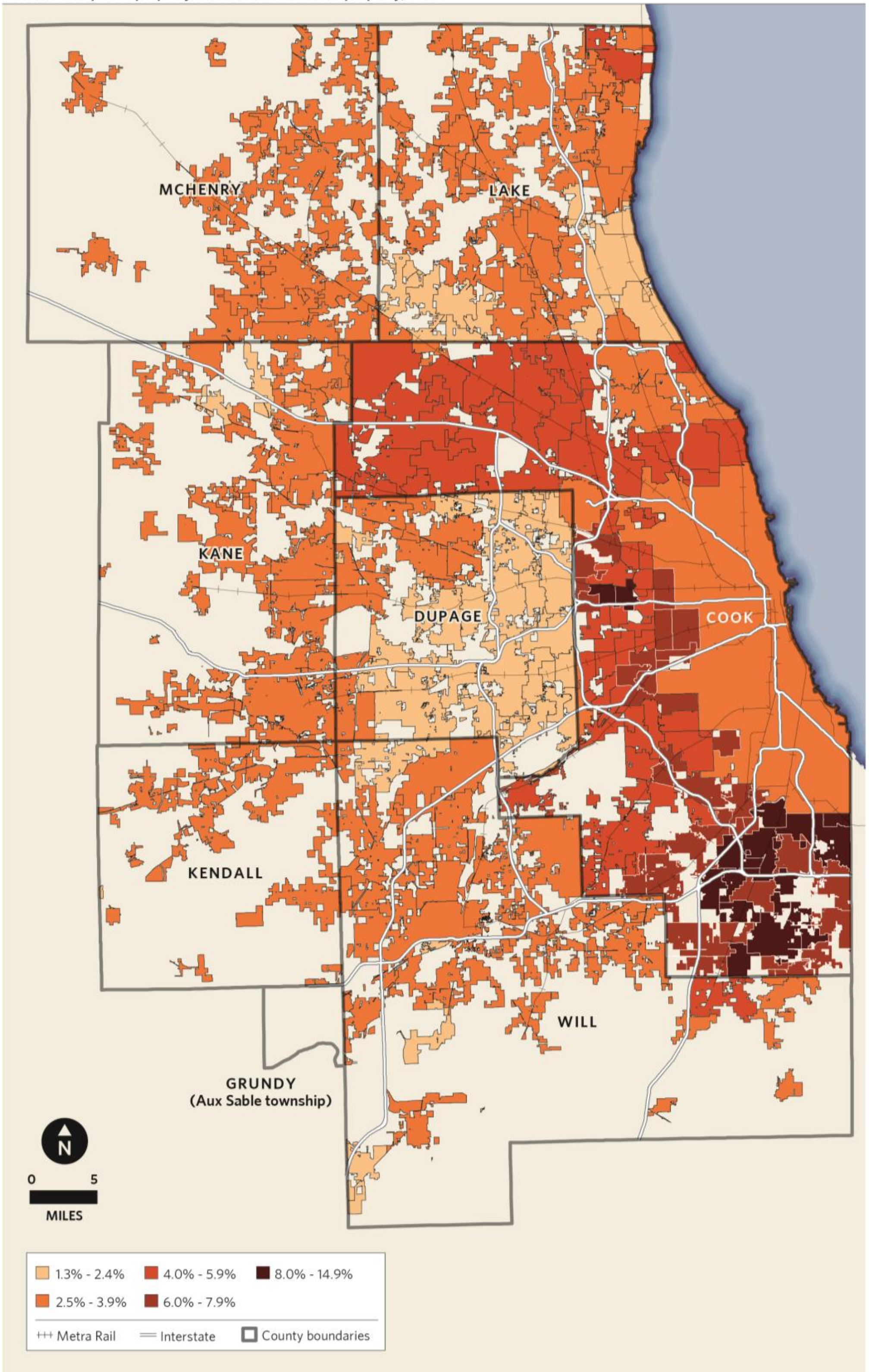
Municipalities receive 1 percentage point of the 6.25 percent rate on general merchandise sales within their borders. They also receive the full amount of the revenues from the 1 percent state rate on qualifying food, drugs, and medical appliances. As this chart illustrates, sharing state sales tax revenue based on location of sales results in highly varied disbursements across the region's municipalities.

CMAP supports implementing policies that phase out property tax classification in Cook County.

Unlike any other county in the state, Cook County assesses commercial and industrial properties at a higher percentage of market value than residential properties. This results in a greater property tax burden on commercial and industrial property taxpayers. CMAP supports implementing policies that phase out this regional inconsistency, but over a period of years to allow residential taxpayers to adjust.

Moreover, reforming classification would both improve the economic development potential for Cook County and promote CMAP's overall development goals. High tax rates can prompt a cycle where new businesses do not locate in the community, resulting in a tax base that grows more slowly than the cost of public services, which can lead to even higher tax rates for businesses and residents alike. Furthermore, a major goal of GO TO 2040 is to attract development in communities with existing infrastructure and available infill land that is vacant or underutilized. For a number of Cook County communities that have high property tax rates, elimination of Cook's classification system could help encourage redevelopment. The following map illustrates typical or average effective property tax rates for industrial property in northeastern Illinois, by municipality.

Effective composite property tax rates for industrial property, 2009



Note: These rates equal the property tax extension as a percent of market value. These composite rates are inclusive of rates levied by counties, municipalities, school districts, and special districts.

Source: Various County Clerk offices.

This map illustrates effective composite property tax rates levied for industrial property taxpayers by municipality in 2009. "Effective" means that rates are expressed as a percent of the market value of properties, rather than the equalized assessed value of properties. The rates shown are also "composite," which means they include rates levied by counties, municipalities, school districts, and special districts. The rates levied by special service areas are excluded in this analysis. As shown, municipalities in Cook County -- especially in the south suburbs -- have the highest regional tax rates for industrial properties.

Regional benefits of comprehensive tax policy reform

CMAP recommends reforms to the tax structure as part of the implementation of GO TO 2040's vision to strengthen economic development and quality of life in communities across the region. As the region's comprehensive planning agency, CMAP can play a leadership role in providing a regional perspective on sound tax policy. From the agency's perspective, benefits of reforming the tax system include a more equitable system that taxes similar residents and businesses in similar ways, a more efficient tax system that broadens the tax base and lowers rates, and a more financially stable tax system that ensures fiscal sustainability.

By implementing reforms in line with these principles, state and local governments will be able to generate adequate and sustainable revenues to support public services, while avoiding inefficiencies and inequities that impair economic growth. CMAP will continue to provide regional leadership in sound tax policy to facilitate the implementation of GO TO 2040's goals.