

Illinois Association of Realtors

Impact of the Proposed Gross Receipts Tax (GRT), Part I May 9, 2007

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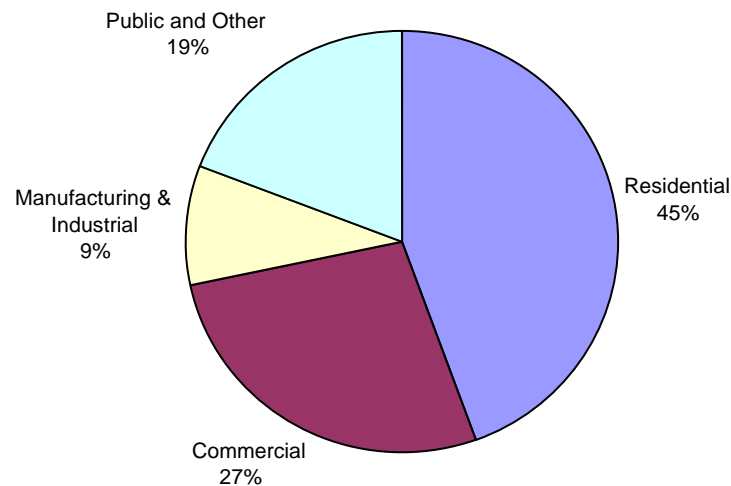
Scope of This Report

1. Housing Price Cascade
2. Impact of GRT on Real Estate Brokerage Income
3. Effects of Slowdown in Illinois Economy on New Housing Construction
4. Who Really Pays the GRT?

1. Housing Price Cascade

45 Percent of Illinois Construction Activity is Residential

Construction in Illinois by Type and Revenue (billions)



Source: 2002 Economic Census

Composition of Residential Construction, 2002

- Single Family, detached = \$13.2 billion
- Single Family, attached = \$2.8 billion
- Apartment Buildings = \$3.1 billion

Information Sources for Price Cascade

- Developers, General Contractors, Subcontractors, Wholesalers, Realty Firm
- U.S. Census, U.S. Bureau of Labor Statistics, Multiple Listing Service of Northern Illinois
- Input-Output Tables

Example

Stages of Analysis in the Price Cascade for Residential Housing

- Stage 1: Wholesaler
- Stage 2: Subcontractor
- Stage 3: The General Contractor
- Stage 4: The Developer
- Stage 5: The Consumer

Stage 1: A Wholesaler

- Materials account for 65% of wholesaler's expenses
 - Buys half of its materials from out of state
 - Wholesaler's suppliers paid GRT at 0.85% on these
- Wholesaler purchases a quantity of services in-state—5% of total expenses
 - Telephone, electricity, insurance, legal and accounting services, and other so-called "soft costs"
 - Those service suppliers paid 1.95% on their gross receipts and pass on that added cost to the wholesaler
- The wholesaler's costs would be raised by
 - $0.0085 \times 0.65 \times 0.5$ for the in-state half of its materials
 - 0.05×0.0195 for the services it purchases
 - Total increment of 0.37%.
- Its gross receipts, having been increased by 0.37% to cover its cost increases, would then be taxed at 0.085. Thus, with its costs 1.0037 times what they were before the GRT, to pass on the tax, its new prices would have to be 1.0085 times 1.0037 to keep its income intact.
- **The result is prices are 1.23% higher than what they were before the tax.**

Stage 2: A Subcontractor

- Buys materials and hires labor to assemble component parts of a building; also purchases some services
- Before the GRT, 35% of its gross expenses went to purchases of materials from wholesalers
 - Materials costs increase 1.23% because of the GRT passed through by the wholesaler
- Services accounted for 5% of gross expenses prior to the GRT
 - Those providers are taxed at 1.95% and pass the cost on to the subcontractor
- Because of its increased costs, the subcontractors overall costs increase 0.53%
- It will pay 0.085% of that in gross receipts tax.
- To keep its net income constant, it must raise its prices by 0.085%, and its post-tax prices will be 1.0053×1.0085 times its pre-tax prices
- **Yields prices 1.38% higher than they were before the GRT**

Stage 3. The General Contractor

- Assembles a team of subcontractors to construct a building
- Different types of subcontractors will experience different effects on their costs because of the GRT, but for simplicity, suppose for the moment that they all face the same cost increase as that calculated above for the generic subcontractor
- Suppose that
 - Subcontractors, including the materials they purchase, account for 70% of the general contractor's costs
 - Purchased services account for 10% of the general contractor's expenses
- Then 70% of the general contractor's costs will have increased by 1.38%, and 10% of its costs will increase by 1.95%
- Overall, the general contractor's costs will increase by 1.16%
- Then, the general contractor's gross receipts are taxed at 0.085%
- **To keep its net income constant, it increases its price by 1.0085×1.0116 , or 2.02%**

Stage 4. The Developer

- Plans the construction of the building and hires the general contractor to implement its construction.
- Suppose that
 - Permits and fees account for 5% of the developer's expenses
 - Taxable services, including interest costs during construction, account for another 5%
 - Non-taxable labor costs account for another 1%
 - 5% profit margin.
- Thus, 5% of the developer's costs will increase by 1.95% to cover the cost of the tax, 6% are not subject to further tax, and 89% increase by 2.02%
- To keep net income constant, the price charged for this building must increase by $.0195 \times 0.05 + 0.89 \times 0.0202$, or 1.89%
- Now, the developer must pay the gross receipts tax on revenues that are 1.89% higher than before
- **To keep income constant, the price of his building must increase by another 0.85%: by 1.0189×1.0085 , or 2.76%**

Stage 5. The Illinois Consumer

End Result in this Example

- **The consumer will pay an additional 2.76% for housing, based on taxes with rates of 1.95% on services and 0.85% on construction contracts and materials**

Results Based on Detailed Investigation of Housing Cost Components

- Identifies over 30 separate building components by subcontractors and materials
- Components combined into 8 types of subcontractors
- Identifies in-state and out-of-state purchases for each contractor type
- Adds the manufacturing stage prior to wholesaler's stage

Types of Subcontractors in Detailed Investigation

- a. Electrical
- b. Plumbing
- c. Carpentry (Framing)
- d. Carpentry (Finish)
- e. Roofing
- f. HVAC
- g. Foundation
- h. Excavation

Stages of Transactions in Detailed Investigation

- Stage 0: Manufacturers
- Stage 1: Wholesalers
- Stage 2: Subcontractors
- Stage 3: General Contractor
- Stage 4: Developer
- Stage 5: Consumer

Total Price Cascade Result

Results of Detailed Investigation

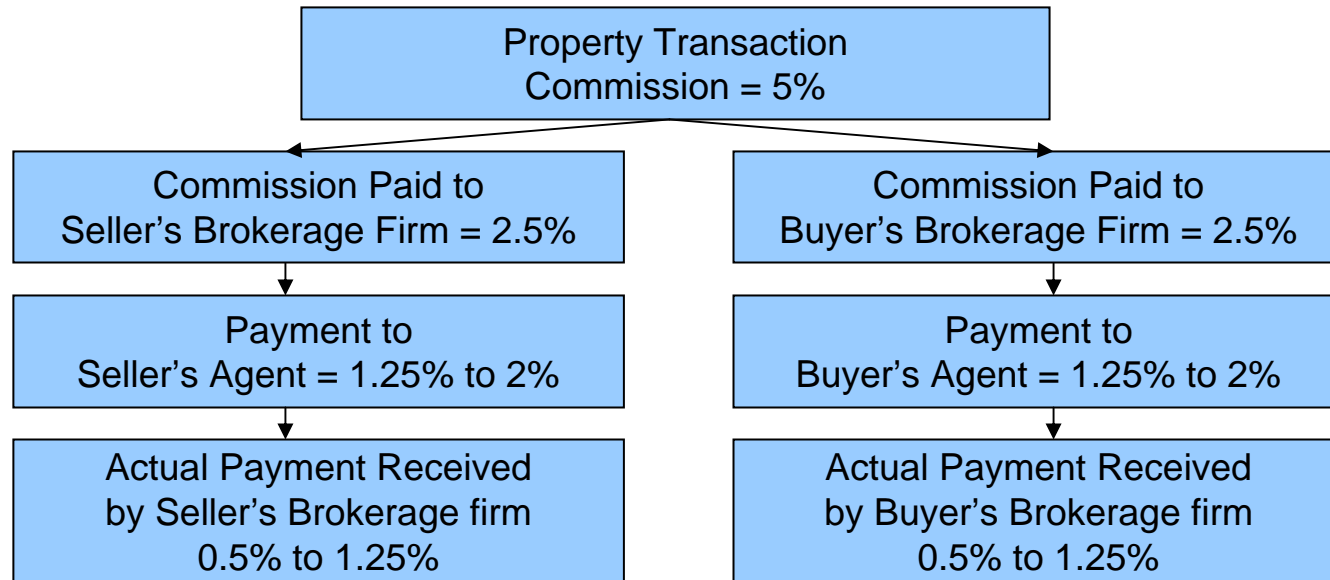
**House price would increase by
2.84%**

2. Impact of GRT on Real Estate Brokerage Income

Impact of GRT on Real Estate Brokerage Firms

- Real Estate Brokers serve as a clearinghouse for commissions.
- Of a typical 5% commission paid to a listing broker, 2.5% immediately goes to the buyer's broker. In addition, another 1.25% to 2% of the remaining commission is paid immediately to the buying agent.
- Therefore, the actual revenue to the broker is approximately 0.5% to 1.25%, not 5%.
- Under the proposed GRT, the broker might be taxed on 100% of receipts, which does not reflect the actual revenue received.

Impact of GRT on Real Estate Brokerage Firms



Example: A brokerage firm sells a total of \$80 million of property in a year. If the proposed GRT is levied on the total commission to the seller's brokerage firm:

Gross Receipts (2.5% of \$80 million) = \$2,000,000

GRT tax of 1.95%, if levied on this amount = \$39,000

If the proposed GRT is levied on the actual payment received:

Actual Payment Received (0.5% to 1.25% of \$80 million) = \$400,000 to \$1,000,000

GRT tax of 1.95%, if levied on this amount = \$7,800 to \$19,500

Impact of GRT on Real Estate Brokerage Firms

Net income of brokerage firm in this example is lower than the \$400,000 to \$1,000,000 actual payments received, due to broker's expenses. GRT effect on net income could be unprecedented.

3. Effects of Slowdown in Illinois Economy on New Housing Construction

Effects of Slowdown in Illinois Economy on New Housing Construction

- Employment in new housing construction produces housing largely for population growth
- Hypothetical Example: If the GRT slows state population growth by 10%—for example, from 0.67% per year to 0.60% per year—employment in new housing construction would fall by 10%
- More work to follow

4. Who Really Pays the GRT?

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Work to be done

- Division between consumers and businesses
- Division between higher-income and lower-income consumers—regressivity
- Larger and smaller businesses