

CENTER FOR TAX AND BUDGET ACCOUNTABILITY

70 E. Lake Street • Suite 1700 • Chicago, Illinois 60601
www.ctbaonline.org

Illinois Must Expand its Sales Tax Base to Reflect the Modern Economy Necessary to Achieve Adequate and Stable State Revenue

Sales taxes play a crucial public finance role for state fiscal systems. If properly designed, sales taxes provide a relatively stable source of state revenue. This is because consumer spending, which accounts for two-thirds of the nation's economy, remains fairly constant even during economic downturns.¹ Since sales taxes typically apply to what consumers purchase, a well designed sales tax will continue producing revenue even when there is a recession.

This is an essential element of public finance in the state government context for one fundamental reason—state governments cannot deficit spend.² When a sales tax fails to provide stable revenue during a recession, the balanced budget requirement forces state governments to cut spending on services—at the very time demand for public services is increasing.

Whether a sales tax has the capacity to generate stable revenue depends primarily on the “base” of the tax. The “base” of a sales tax is simply the items which the tax applies to when sold. To generate stable revenue, a sales tax base must be broad—that is, it must include most of what is being sold in the consumer economy.

During the past two decades, revenues from the Illinois sales tax have grown more slowly than in most other states, even though Illinois has one of the highest sales tax rates in the country.⁴ This is due to Illinois' comparatively narrow sales tax base. John Mikesell, a noted national economist, found that Illinois has a sales tax base which is narrower than 43 of the 46 states with a sales tax.⁵ One consequence of Illinois' narrow tax base is underperformance of the revenue system. A second consequence is Illinois has a greater tax rate than most other states to compensate for its narrow base.

The reason Illinois has a narrow sales tax base is because it excludes almost all consumer services. According to the Institute on Taxation and Economic Policy (ITEP), of the 164 taxable services that could be included in the sales tax base, Illinois taxes only 17. Illinois taxes less services than all its neighboring states, Iowa, Wisconsin, Missouri, Indiana and Kentucky.

This significantly impedes the ability of the Illinois sales tax to perform its intended stabilizing function and **creates a fiscal mismatch between the actual Illinois economy and the portion of the economy taxed to fund public services.** While Illinois' economic base has shifted dramatically over the last three decades from goods to services, there has been no corresponding change in how Illinois taxes.

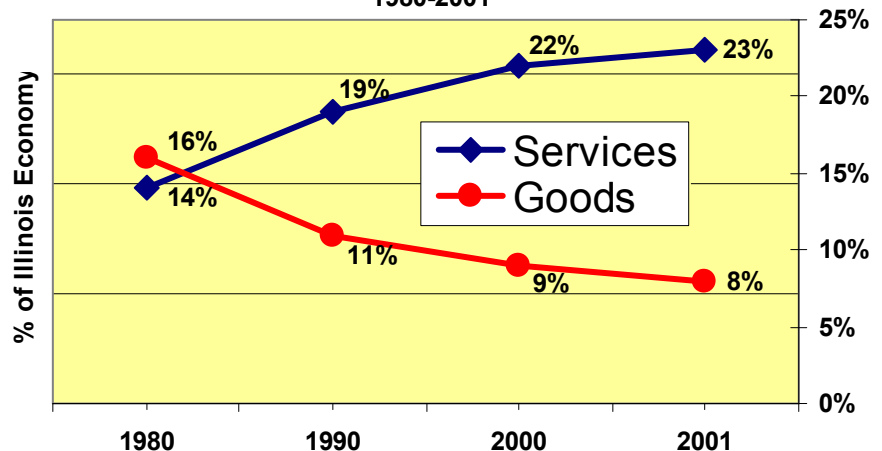
Table 2 above illustrates how dramatic this shift in the Illinois economy has been. In 1980 the sale of services—what Illinois does not tax—accounted for 14% of the total Illinois economy, while the sale of goods—what Illinois

Table 1

Illinois Sales Tax

- 6.25%
 - 5% allocated to the state,
 - 1.25% allocated to local government
- Localities are allowed to levy additional sales taxes
- Average sales tax in Illinois is 7.55%³
- U.S. average sales tax is 6.9%³

Table 3
Consumer Goods & Service Sectors as a
% of Total Illinois Economy
1980-2001



1 Center for Budget and Policy Priorities, <http://www.cbpp.org/6-19-03sfp.pdf>

2 IL Const. art. VIII, § 2 note: 49 of the 50 states have balanced budget requirements.

3 Sales Tax Clearing House: <http://www.taxch.com/STrates.stm>

4 Institute on Taxation and Economic Policy, *Balancing Act: Tax Reform Options for Illinois*, pg. 4.

5 John Mikesell, "Remote Vendors and American Sales and Use Taxation," *National Tax Journal* 53/4 p. 1273 (2000).

does tax—accounted for 16%. By 2001, the sale of services increased dramatically, to represent 23% of the state’s economy, while the sale of goods dropped precipitously, losing half of its value as a portion of the Illinois economy in only twenty years. Put another way, what Illinois taxes was rapidly losing value while what Illinois does not tax was rapidly gaining value.

The service sector is now the largest and fastest growing segment of the Illinois economy.⁶ Imposing a sales tax on services would simply be responsive to real world economic trends. Ignoring this change in the state’s economy, however, will result in ongoing deficits and tax revenue underperformance.

The potential yield of an expansion of the Illinois sales tax to the service industry is a difficult number to estimate. The Governor’s Commission on Property Tax Reform in 1998 conducted one of the more thorough studies analyzing the application of sales taxes to a broad array of services. Table 3 below summarizes and updates the Commission’s estimated potential sales tax yields.

Table 3

Category	Estimated State Sales Tax in 2003
Personal Services	\$122.7 million
Business	\$1.231 billion
Automotive Services	\$274.0 million
Miscellaneous Services	\$94.1 million
Amusements	\$323.0 million
Legal	\$343.5 million
Engineering & Accounting	\$740.1 million
TOTAL SALES TAXES	\$3.128 Billion

A more recent study was conducted in December, 2002, for the Center for Tax and Budget Accountability (CTBA) by J. Fred Giertz of the Institute of Government and Public Affairs. The study summarizes data initially drawn from 1997 and then updated through 2003 (using some estimates), and examines two distinct sales tax expansion options. Under the first option, the sales tax base would include most personal and entertainment services but would exclude all other services, business or consumer. That modest expansion of the sales tax base was estimated to generate \$580 million back in FY2004.

Under the second option, the sales tax base would include most personal and entertainment services, as well as other consumer services such as repairs, home cleaning and maintenance. It was estimated that this second option would have generated approximately \$1 billion in FY2004. CTBA does not recommend expanding the sales tax base to include any: business services, because that could result in double taxation of the same transaction; health care services, because that could discourage low and moderate income taxpayers from seeking medical attention; or housing rent, because renters already pay property taxes as a component of their rent.

Moreover, since sales taxes are regressive, care must be taken to offset the impact of additional sales taxes on low or middle income families with a refundable credit. Otherwise the Illinois tax system, already one of the most unfair and regressive in the nation, would become even worse.

For more information please contact Chrissy Mancini at 312-332-1481 or cmancini@ctbaonline.org