

# Issue Brief

## Illinois Must Expand its Sales Tax Base to Reflect the Modern Economy

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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.<sup>1</sup> 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.<sup>2</sup> 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.

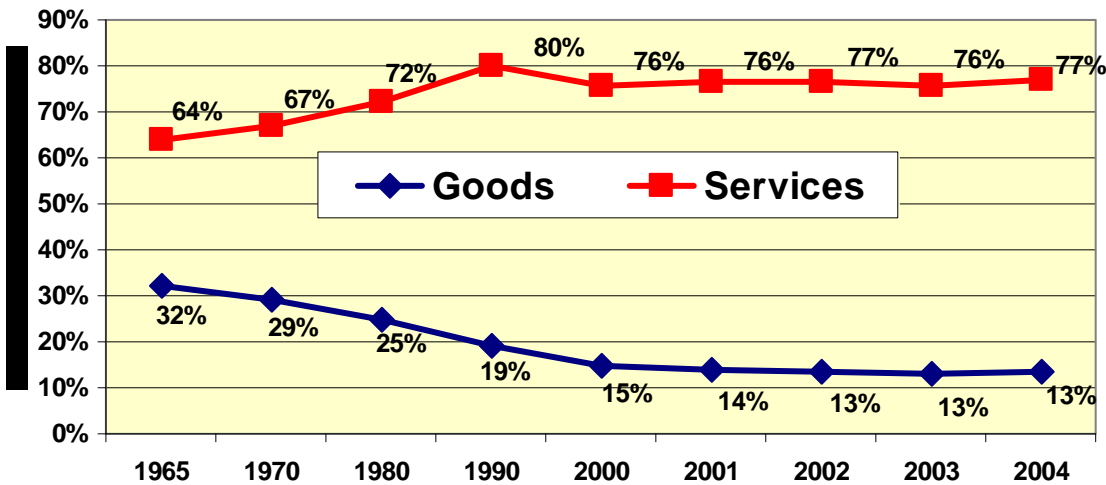
**Table 1**

### 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%<sup>3</sup>
- U.S. average sales tax is 6.9%<sup>3</sup>

**Table 2**

### Goods and Service Sectors as a Percent of the Total Illinois Economy



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.<sup>4</sup> 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.<sup>5</sup> 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 Federation of Tax Administrators, 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.

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

4 Federation of Tax Administrators, Sales Taxation of Services Survey.

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



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 illustrates how dramatic this shift in the Illinois economy has been. In 1965 the sale of services—what Illinois does not tax—accounted for 64% of the total Illinois economy, while the sale of goods—what Illinois does tax—accounted for 32%. By 2004, the sale of services increased dramatically, to represent 77% of the state's economy, while the sale of goods dropped precipitously, losing more than half of its value as a portion of the Illinois economy. 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.<sup>6</sup> 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.

Expanding the current Illinois Sales Tax base to include consumer services (not business, health care or housing services) at the current state rate of 5.0% would generate approximately \$1.7 billion in new revenue. Options for both the expansion of the base to include consumer services with a reduction in the sales tax rate would generate:<sup>6</sup>

**Table 3**

Rate	Additional Revenue Generated (\$ in millions)
3.0%	\$-1,810
3.5%	\$-937
4.0%	\$-57
4.5%	\$822
5.0%	\$1,700

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.

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### *ABOUT CTBA*

Founded in 2000, the Center for Tax and Budget Accountability is a non-profit, bi-partisan research and advocacy think tank committed to ensuring that tax, spending and economic policies are fair and just, and promote opportunities for everyone, regardless of economic or social status.

CTBA uses a data-focused, bipartisan approach to work in partnership with legislators, community groups and other organizations to help change both public policy and perceptions.

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5. Calculations based on actual Fiscal Year 2006 Illinois Sales Tax receipts data from the Illinois Commission on Government Forecasting and Accountability.

6. State of Working Illinois: [http://www.stateofworkingillinois.niu.edu/swil/pubs/swil\\_report.pdf](http://www.stateofworkingillinois.niu.edu/swil/pubs/swil_report.pdf)

