The Illinois Budget Policy TOOLBOX

Tools to Address Revenue

The Sales Tax

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February 18, 2014

The sales and use taxes and the income tax are the pillars of the Illinois state revenue structure, accounting for 22.4 percent of state tax revenue in FY2012. The $7.6 billion generated by sales taxes is equal to slightly less than one-half of individual income tax revenue (under the temporary 5 percent rate approved in 2011). In addition, the state has a number of other consumption-based taxes such as taxes on utilities, tobacco, alcohol, motor fuels and automobile rentals.

Illinois imposes a tax of 6.25 percent on non-exempt transactions. The state retains 80 percent of the tax (5 percentage points), and the remainder (1.25 percentage points) is distributed to local governments where the sales took place. In addition, certain local governments can impose additional sales taxes at their discretion. In effect, certain jurisdictions (including much of Cook County and Chicago) have combined rates of 9 percent or more. The state rate of 6.25 percent is above the midpoint compared to 45 states that impose sales taxes. However, when local add-ons are included, many jurisdictions in Illinois have among the highest rates in the nation.

Therefore, increasing the state's sales tax rate is problematic. Such an action would increase disparities between Illinois and its neighbors, potentially leading to flight by consumers to other states for purchases. However, base broadening and base refinement each have the potential for making the Illinois sales tax fairer and more responsive to economic growth while increasing revenue.

Tax reform and tax enhancement efforts could also address other issues. Illinois' sales tax departs in a number of ways from a broad-based consumption tax that it is supposed to embody. The result is decreased revenue production, market irregularities, and fairness issues.

Ideal and actual sales taxes

A general sales tax is intended to be an ability-to-pay tax where consumption is used as the measure of economic capacity. Income, wealth, and consumption are the three basic ways of measuring ability-to-pay. State and local governments in Illinois use all three of these approaches with the income, property, and sales taxes.

The consumption base of the sales tax leads to what is known as the "destination principle" of taxation: the tax is imposed where the consumption takes place, not where the good or service is produced (as with the "origin principle"). Goods and services produced in Illinois that are consumed in other places are not taxed here, while goods and services consumed in Illinois are supposed to be taxed in the state regardless of where they are produced. Thus, states with sales taxes almost always have related use taxes imposed on out-of-state purchases by residents. This aspect is important for e-commerce transactions, where states have difficulty in collecting use taxes from remote vendors.

The basic idea of a sales tax is to tax consumption once (and only once) at the point of the final transaction between the retailer and consumer. Consumption includes both goods and services, and the theory of sales taxation makes no distinction between these two categories. For example, health club memberships would be taxed just as is exercise equipment, and dry cleaning services would be taxed similar to the way washers, dryers, and detergents are taxed. The goal of taxing consumption only once implies that business-to-business sales would be excluded from taxation, since these transactions eventually find their way into the final cost of the good that will be taxed later at the retail level.

A broad consumption base for the sales tax tends to be both fair and efficient. A broad base does not arbitrarily reward or penalize certain types of consumption, thus not biasing economic behavior.[1] A broad base allows a given amount of revenue to be collected with the lowest possible tax rate, thereby imposing a lower burden on consumers and producers. Sales taxes tend to be moderately regressive when the annual tax burden is taken as a fraction of annual income. Lower income taxpayers spend a larger share of their incomes on taxed items compared to those with higher incomes, so the annual tax burden as a fraction of annual income is higher for those with less income. Note this does not mean that the poor pay more, only that they pay a larger percentage of their incomes. When the burden is calculated as a fraction of lifetime income, the tax is less regressive and closer to proportional, since the ratio of lifetime consumption to lifetime income does not vary as much among income levels.

However, in Illinois and most other states that employ a sales tax, the actual tax base departs markedly from the so-called ideal broad base. In particular, the Illinois sales tax applies to only a minority of actual consumption activity. The two largest exclusions from the conceptual base are consumer services and food. Some of these omissions are based on equity concerns. For example, Illinois does not tax housing services (rent), although it does tax material used in housing construction. The 5 percent state rate also is not imposed on food for off-premises consumption, which is sometimes favored for equity reasons. Lower income consumers may spend a disproportionate share of their incomes on food, shelter, and health care items. The state may want to promote education, health, and housing services with the use of these tax incentives. However, Illinois' exclusion of virtually all consumer services goes far beyond most states in addressing these equity issues. In general, the base of consumer services is growing faster than goods, and its exclusion disproportionately benefits higher income taxpayers who spend a larger share of their incomes on services than lower income taxpayers. The resultant narrow base explains, in part, the relatively high tax rate, the slow growth of tax revenues, and some of the regressivity of the sales tax.

While excluding a number of items from the base that would be taxed under a pure sales tax, Illinois includes many business-to-business purchases that would not be taxed under a pure sales tax. The result is tax pyramiding, where the same good is taxed multiple times during the production process. This practice is contrary to some goals of tax policy, but it does generate additional revenue.

Illinois' lack of clarity in regard to the tax base is illustrated in the *Comptroller's Tax Expenditure Report*.[2] Tax expenditures are implicit subsidies that are provided through exemptions in the state tax system rather than more directly though state spending. The report correctly cites the exclusion of food, drugs, and medical appliances from the base as tax expenditures (estimated at $1.6 billion in lost revenue in FY 2012), but it completely ignores the exclusion of services as a lost revenue item. The exclusion of consumer services from the sales tax base results in revenue losses far exceeding the food exemption, but it is completely ignored in the comptroller's report. On the other hand, the report lists the manufacturing machinery exemption and the farm chemical exemption as tax expenditures, i. e., subsidies to business, when in fact they merely represent sound tax policy where business-to-business sales are not taxed.

Reform of the sales tax

A number of changes in the sales tax would improve the fairness and efficiency of the tax. These reforms would often either generate extra revenue or allow the existing tax rate to be lowered.

Taxation of consumer services. Illinois could consider including consumer services in the sales tax base. The state has no well-defined reason other than historical

[1]For a further description of why the uniform treatment of all goods and services minimizes excess costs of economic inefficiency, see the entry by Fullerton in this toolbox, *Competing Goals of Budget Policy Reforms.*

[2]Illinois State Comptroller, *Tax Expenditure Report*, July 2013 http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/

precedent to tax one type of consumption (goods or tangible personal property) while excluding the consumption of services. The taxation of consumer services would increase the responsiveness of the sales tax to economic growth and reduce its regressivity while potentially generating substantial extra revenue. Estimates of the extra revenue may be overly optimistic because they also envision taxing business-to-business services such as advertising, accounting, legal, architectural, and engineering services. The taxation of housing, health, and education services is also unlikely.

Eliminate the state exemption for food. The exclusion of food from the sales tax base was intended as an equity measure to reduce the impact on low-income taxpayers.[3] This feature is a blunt and costly instrument to achieve this goal. The exclusion applies to lobster and filet mignon as well as to rice and beans. Furthermore, purchases made by low-income consumers using food stamps are not subject to taxation because of federal rules. The result is an extremely expensive device to provide modest relief to some low-income consumers. It is widely understood that the sales tax is not positioned to provide targeted tax relief in an efficient manner. The state could consider eliminating the exclusion of food while providing relief to low-income taxpayers through the earned income tax credit or other measures such as a refundable income tax credit.

Pursue the collection of e-commerce purchases under the use tax. Illinois and other states are losing substantial and growing amounts of tax revenue from purchases over the internet from out-of-state vendors (on sales to Illinois residents). Note that taxes on such purchases are now correctly subject to the use tax, but the tax is often difficult to collect. This situation creates a loss of tax revenue as well as a disadvantage to in-state brick and mortar retailers who must collect the tax for the state.

Some remote vendors who have some presence in Illinois—known as nexus – already collect the use tax, but many others do not. The solution to this problem is not strictly in the control of Illinois or any other state. Yet Illinois could aggressively pursue collecting the use tax wherever possible. The state could also consider fuller participation in the Streamlined Sales Tax consortium as a way of furthering this process. More importantly, the state could try to influence the federal government to require the collection of all states' use taxes by large vendors. After more than a decade of work in this area, federal action is being seriously considered.

Consider the removal of business-to-business transactions from the base. The state could consider ways to gradually reduce the taxation of business-to-business transactions, since these transactions are not appropriately included in a consumption base, and they result in the pyramiding of taxes with arbitrary and capricious results. This reform could probably be considered a long-term goal because of its negative revenue impacts and because it is likely to be politically unpopular. The appearance of reducing taxes on business while expanding taxes on consumers would be a difficult political issue.

Avoid tax gimmicks such as tax holidays and amnesties. The state could avoid sales tax holidays regardless of their political popularity. Holidays and amnesties undermine the long-term functioning of the sales tax and result in little benefit.[4] •

[3]This exclusion of food, drugs, and medical appliances is estimated to reduce state revenues by $1.6 billion in FY2012. Illinois State Comptroller, *Tax Expenditure Report*, July 2013 http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/ (see page 5).

[4] Tax Foundation. (July 2013). *Sales tax holidays: Politically expedient but poor tax policy*. Available at http://taxfoundation.org/article/sales-tax-holidays-politically-expedient-poor-tax-policy-2013

Further Reading

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