CMAP

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THE BENEFITS OF ADDING MORE SERVICES TO ILLINOIS' SALES TAX BASE

This analysis is one of a series examining transportation funding in northeastern Illinois and explaining the revenue recommendations included in ON TO 2050. This analysis explores how expanding the sales tax base to additional services would benefit the region. Other analyses in the series examine existing revenue sources for the regional transportation system, and explain recommendations including increasing the state motor fuel tax and eventually replacing it with a road usage charge, expanding parking pricing, using tolling and value capture to fund transportation improvements, and implementing a federal cost of freight service fee.

Sales taxes in Illinois are imposed primarily on tangible goods, not consumer services. This structure has led to unintended consequences for the State and local governments that rely on sales taxes, particularly as consumer behavior changes. Consumer expenditures on services such as personal care, clothing services, and household maintenance in Illinois grew 3.6 percent on average every year over the past 20 years, while expenditures on goods such as clothing and footwear and motor vehicles grew at average rates of 1.3 percent and 1.2 percent respectively.

As the consumption of services rises faster than the consumption of goods, the sales taxes that fund state, county, and municipal governments as well as the transit system in northeastern Illinois have become less sustainable. The Regional Transportation Authority (RTA) relies heavily on sales taxes to operate the region's transit system, which is aging and in significant need of investment. Indeed, most dedicated transit funding resources are used for operating costs, and no dedicated capital funding source exists to pay for reconstruction and replacement—yet some 31 percent of transit assets in the region are beyond their useful life.

ON TO 2050 recommends that the State of Illinois modernize and expand its sales tax base to include additional services in a manner that generates needed revenue for transit, helps communities create a more balanced land use mix, ensures similar consumers are taxed in similar ways, minimizes the influence of taxation on consumer purchases, and mitigates the cascading nature of sales taxes. This Policy Update outlines why expanding the sales tax base would benefit the region.

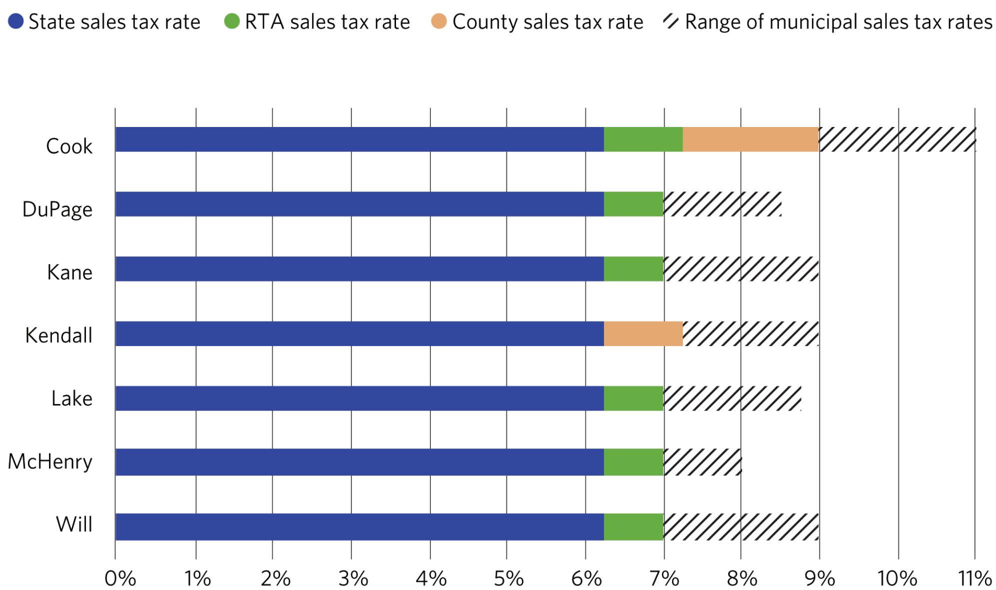
The state has a narrow sales tax base and a high rate

The Illinois sales tax base, which applies to all state and local sales taxes, including the RTA sales tax, excludes most services. The chart below depicts rates by jurisdiction and county.

Sales tax rate ranges by county, January 2019

Note: Excludes Business District sales tax rates.

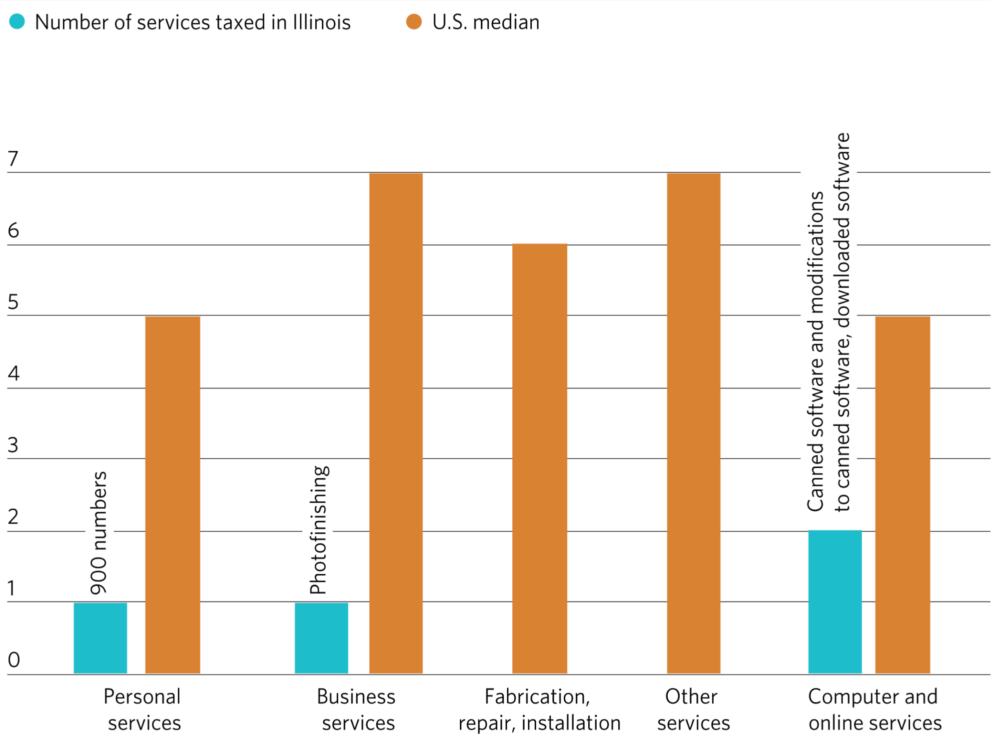
Source: Chicago Metropolitan Agency for Planning analysis of Illinois Department of Revenue data, January 2019



Illinois taxes few services, with a sales tax base that is narrower and a sales tax rate that is higher than most other states: Illinois ranks 43rd in the country for the breadth of its sales tax base, but 13th for its sales tax rate. Nationally, the median sales tax base included 50 non-utility related services in 2017, while Illinois' included just four non-utility related services. The following chart provides an overview of the services Illinois includes in its sales tax base compared with the national median for selected categories. The state does tax electricity, natural gas, telecommunications services, hotel and motel rooms, and automobile rental services under separate rates and authorities, similar to taxes found in other states. However, these taxes do not reflect the broad array of services that consumers increasingly use in lieu of retail goods. For example, many consumers purchase lawn care services rather than their own equipment and materials. Expanding the base would reflect modern purchasing patterns. The current list of taxable services — photofinishing, canned software, and 900 numbers — aptly demonstrates its outmoded nature.

Number of services included in Illinois sales tax base compared with national median, selected categories, 2017

Source: Chicago Metropolitan Agency for Planning analysis of Federation of Tax Administrators' 2017 Survey of Services Taxation.



Consumers are purchasing more services

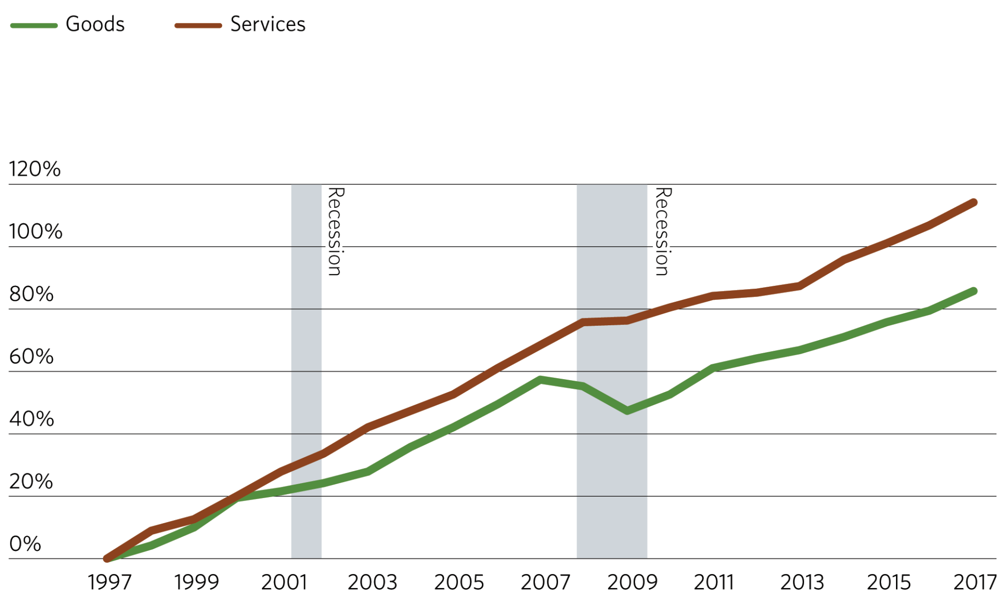
Many of the services that Illinois excludes from its sales tax base have experienced rising consumer demand. The service sector of the economy accounts for a larger proportion of consumer spending than it did in 1933 when Illinois adopted its sales tax. In the intervening 85 years, the U.S. transitioned from an economy based on manufacturing and other goods-producing industries to a services and information-based economy. With this transition came cheaper and more efficiently manufactured goods from within the country and overseas, rising standards of living, and increased disposable income, resulting in increased demand for services.

The following chart illustrates consumer expenditures on goods as compared to consumer expenditures on services such as communications, education, personal care, laundry and dry cleaning, and household management. While consumer expenditures on goods rose 85.9 percent between 1997 and 2017, consumer expenditures on these services rose 114.1 percent.

Illinois personal consumption expenditures, percent change since 1997

Note: Goods include all goods categories, plus food services and accommodations, to better reflect expenditures already in the sales tax base. Services includes the other services category comprised of communications, education, personal care, clothing services, and household maintenance expenditures.

Source: Chicago Metropolitan Agency for Planning analysis of U.S. Bureau of Economic Analysis data.



The current sales tax structure is not fiscally sustainable

The sustainability of the sales tax base is precarious because consumption of services continues to rise faster than the consumption of goods. Since 1970, the typical sales tax base in the U.S. has become 20 percent narrower in terms of percent of personal income. As the sales tax base becomes narrower relative to income and consumption levels, the only way to preserve sales tax revenue growth relative to other state and local government revenues, as well as the cost of public services and infrastructure, is to expand the base or increase rates.

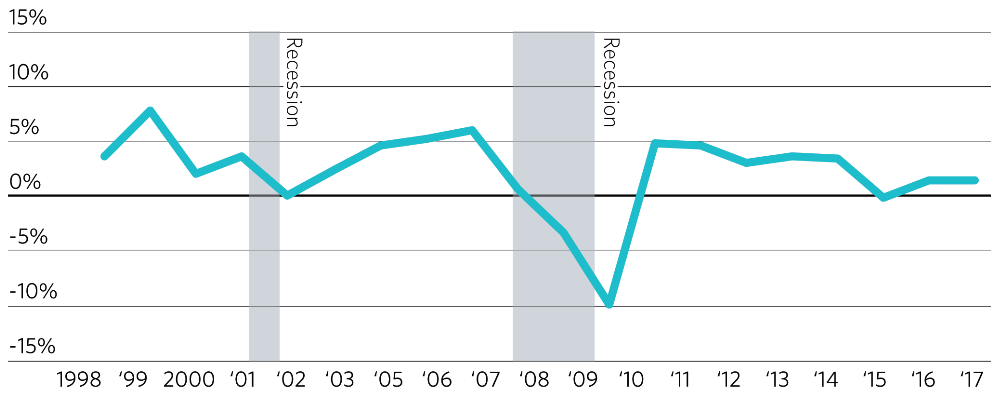
Under current rates, an expansion of the sales tax base would provide additional revenue for the State of Illinois and local governments grappling with resource constraints and potentially allow for reduced sales tax rates. If current RTA sales tax rates, which vary in Cook and the collar counties, remained the same, an expansion would generate more revenue, potentially providing more funding for transit operating costs and freeing up other revenues to use for capital improvements. CMAP estimates that if the sales tax base grew by 15 percent, an additional $11 billion would accrue to the RTA and collar counties through the RTA sales tax, 2019-50. For the State of Illinois, the Commission on Government Forecasting and Accountability has estimated the impact of expanding the sales tax base to services taxed in other states.

Narrow tax base does not align with communities', consumers' desired choices

The narrowness of the sales tax base also affects the ability of local governments to support their desired development patterns. Under the current sales tax base, communities with many service-based businesses have few revenue options to sufficiently cover the cost of public services and infrastructure necessary for that development. Moreover, some local governments limit space for development that does not generate sales taxes from commercial areas. Broadening the sales tax base to additional services would help ensure that all communities have the ability to generate revenue that supports the range of development identified in their planning goals.

Expanding the base to consumer services using the widest net possible to capture consumer spending would reduce volatility and the influence of the tax system on consumer choice. The sales tax is one of the more volatile taxes imposed, and even more so when it is imposed on a narrow base. In general, research indicates that a larger and more diverse tax base would bring more year-to-year stability to sales tax revenues. Expanding Illinois' sales tax base would lessen the impact of changes in consumer preferences and consumption patterns on sales tax revenues. The following chart illustrates volatility in state sales tax revenue over the past two decades.

Annual percent change in state sales tax revenue, 1998-2017



Source: Chicago Metropolitan Agency for Planning analysis of Illinois Department of Revenue data.

Likewise, expanding the base would have the benefit of reducing economic distortions. The structure of the sales tax inadvertently influences consumers' purchase of different goods and services based on whether or not they are taxed. For example, under the current system, a consumer can get upholstery cleaning services tax-free, but must pay a tax to buy upholstery cleaning equipment or new upholstery. Minimizing economic distortions would encourage consumers to purchase goods or services to maximize their own welfare, rather than as a response to tax burdens.

Implementation should focus on consumer services

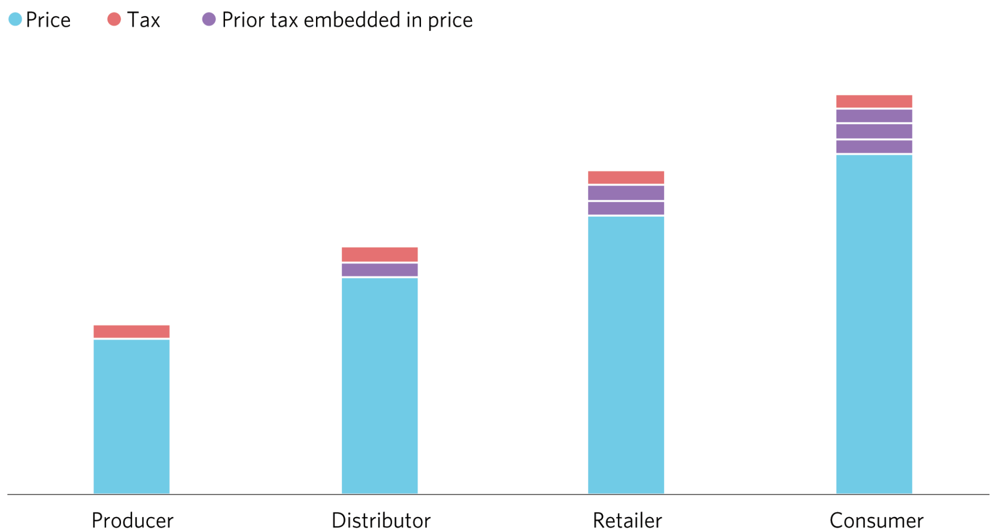
While some states already tax an array of services, others have increased their sales tax base in recent years. Connecticut added 12 primarily consumer services to its base in 2011, and two additional services in 2015. Connecticut now includes 99 services in its sales tax base, up from 85. North Carolina also significantly expanded its sales tax base in 2016 and 2017 to all repair, maintenance, and installation services, which had the result of increasing the number of services in its sales tax base to 62 from 36. In 2018, Kentucky expanded its sales tax to an additional 17 services, such as automotive repair, dry cleaning, and pet grooming.

Illinois would need to carefully consider which services to include in an expanded sales tax base. ON TO 2050 recommends focusing on services that are primarily purchased by consumers. To maximize the benefits of expanding the tax base, policymakers should consider being as inclusive as possible when determining consumer services that would be taxed. Taxing a small set of services may not sufficiently expand the tax base. In particular, while services such as tailoring or bowling may have a place in the tax base, alone they would not produce enough revenue nor would it accomplish the broader goals of improving the tax system.

Taxing business inputs — such as accounting services — would be problematic because businesses pass the cost of sales taxes on to the consumer. As illustrated below, when the customer pays a sales tax on their purchase, the result is a tax on a tax. If additional business inputs were added to the sales tax base, the cascading nature of the sales tax would be amplified.

The effect of taxing business inputs on taxation

Source: Chicago Metropolitan Agency for Planning analysis of Tax Foundation information.



While a sales tax base expansion would provide additional revenue for the State of Illinois, the RTA, counties, and municipalities, these entities would also have the opportunity to reduce their tax rates in order to balance growth in the base with their revenue needs. The sales tax is a regressive tax, but lowering rates would help to reduce the burden on lower income taxpayers. Whether adding additional services to the tax base without lowering rates would make the tax more regressive would depend on the specific services added to the base.

The State will also need to consider how to best source the sales of services. The Retailers' Occupation Tax in Illinois uses origin-based sourcing, meaning the tax is applied at the point where the sale originated. However, many states use destination based sourcing, where the tax is collected based on the destination of the sale. For many services as well as tangible goods, origin and destination both occur at the business' location, such as purchases from a store or services performed at a business. However, many services are provided at a customer's home or business. Depending on which services were added to the tax base, different approaches, such as a destination-based method, should be considered in order to ensure that taxes are imposed where the service is being delivered.

Pursuing ON TO 2050 recommendations

Northeastern Illinois must ensure sufficient funding for transportation, and CMAP has outlined four key principles essential to any new revenue proposals. In keeping with these principles, ON TO 2050 recommends expanding the sales tax base to additional consumer services. CMAP and its partners will continue to engage policymakers on this recommendation, which would go a long way toward modernizing Illinois' tax system and facilitating more sustainable revenues for state and local governments, including the region's transit systems.

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