ILLINOIS TAX FACTS

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U.S. Census to Correct Billions in Sales Tax Reporting Error

By Mike Klemens

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A pending Census Bureau update will boost reported Illinois state and local general sales tax collections by more than $2.5 billion a year. Money previously accounted for in intergovernmental transfers will now be properly recognized as sales tax collections. This correction will have a discernible effect on the myriad of studies that rely on the federal data for state-to-state comparisons.

The primary data source for comparisons between and among states is the U.S. Census Bureau's *Census of State and Local Government Finances*. The Census Bureau acknowledges that the Illinois sales tax numbers have been wrong for decades and plans to redo its calculations, at least for recent years. Illinois' state and local general sales tax collections for 2012 will increase by an estimated 26 percent, from $9.6 billion to $12.2 billion. Because this data source is widely used in state comparison studies, this correction will cause both state and local tax burdens to rise.

Here's an example: CQ Press's *State Rankings* contains an annual series of data tables that rank each state on a wide range of criteria, including various aspects of taxation. In the 2015 CQ rankings of state and local general sales

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

If you are an avid or an occasional reader of the ubiquitous studies comparing state tax burdens, you may have wondered why Illinois' sales tax burden ranks below average, even though our rates can be quite high. At the Taxpayers' Federation we did too. So we asked the Census Bureau, which compiles those statistics, and it turns out that the state and local general sales tax collection numbers had been underreported for decades, to the tune of $2.5 billion in FY 2012.

In this issue Mike Klemens discusses the implications of correcting this error, projecting how the correction will affect Illinois' ranking in the various studies. The short answer is less than you might think. Amazingly, $2.5 billion is less than 4 percent of total state and local tax collections.

Once again, this reminds us that taxes are not simple and that even professional bean-counters sometimes get it wrong; consumers of state tax comparison studies should always read them with a critical eye.

tax revenue per capita (for FY 2012) Illinois' figure of $749 put the state at 39th on the list. When the roughly $200 per capita correction is added in, Illinois will rise to 24th (just below Indiana and above Minnesota). See **Table 1**.

The corrections to sales tax collections will also increase Illinois' total state and local taxes collected as well, of course. And, while $2.5 billion is a lot of money, the corrections will increase Illinois' total state and local tax collections by less than 4 percent for FY 2012. The $200 per capita increase will bump Illinois from 10th to 8th in those CQ rankings.

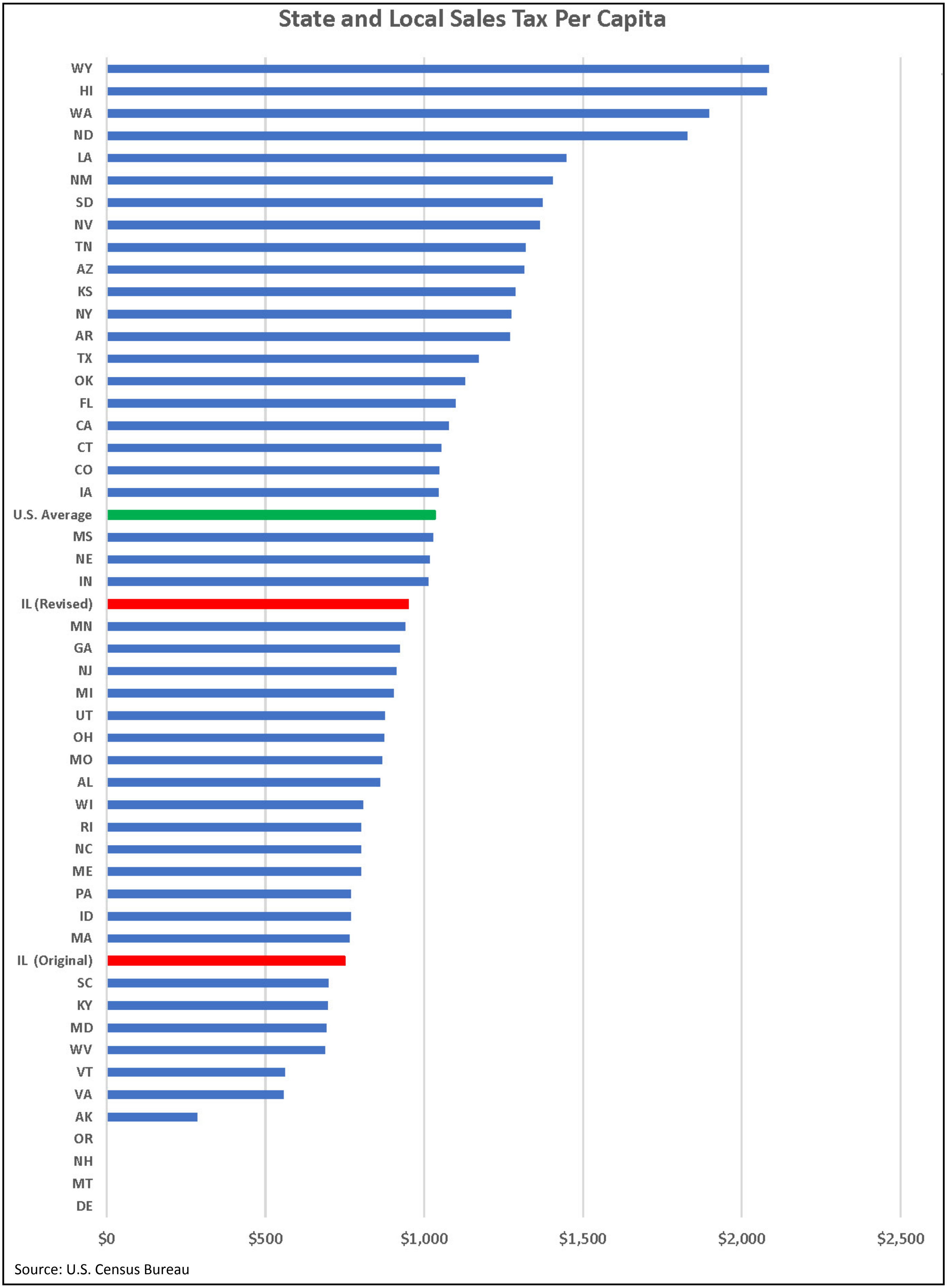
Why this matters, and some context

Getting the numbers right is always a worthwhile goal in and of itself, but when the numbers drive policy debates, it's even more important. For

TABLE 1. Per Capita State and Local General Sales Tax Revenue in 2012

Rank	State	Per Capita
1	WY	$2,086
2	HI	2,078
3	WA	1,897
4	ND	1,828
5	LA	1,447
6	NM	1,405
7	SD	1,373
8	NV	1,365
9	TN	1,320
10	AZ	1,315
11	KS	1,288
12	NY	1,274
13	AR	1,269
14	TX	1,172
15	OK	1,128
16	FL	1,099
17	CA	1,078
18	CT	1,053
19	CO	1,047
20	IA	1,045
	U.S. Average	1,033
21	MS	1,029
22	NE	1,017
23	IN	1,013
	IL (Revised)	949
24	MN	941
25	GA	924
26	NJ	913
27	MI	904
28	UT	875
29	OH	874
30	MO	867
31	AL	862
32	WI	808
33	NC	802
33	RI	802
35	ME	801
36	PA	769
37	ID	768
38	MA	764
39	IL (Original)	749
40	SC	699
41	KY	697
42	MD	693
43	WV	688
44	VT	562
45	VA	557
46	AK	285
47	DE	0
47	MT	0
47	NH	0
47	OR	$0

Source: U.S. Census Bureau


State and Local Sales Tax Per Capita
WY
HI
WA
ND
LA
NM
SD
NV
TN
AZ
KS
NY
AR
TX
OK
FL
CA
CT
CO
IA
U.S. Average
MS
NE
IN
IL (Revised)
MN
GA
NJ
MI
UT
OH
MO
AL
WI
RI
NC
ME
PA
ID
MA
IL (Original)
SC
KY
MD
WV
VT
VA
AK
OR
NH
MT
DE
$0
$500
$1,000
$1,500
$2,000
$2,500
Source: U.S. Census Bureau

example, the corrected data undermines one premise used to support the push to expand the Illinois sales tax to services. Proponents of expansion have argued that despite high combined state and local sales tax rates, Illinois has lagged the rest of the country in per capita sales tax collections because its sales tax base is too narrow. Generally speaking, and unlike many other states, Illinois taxes only the transfer of tangible personal property and not services. Broadening the tax base to include more services would, the argument goes, bring in more revenue and put Illinois more in line with other states in terms of per capita tax collections. The corrected data will demonstrate that Illinois does not lag the rest of the country but is solidly in the middle, meaning this rationale for taxing services needs to be reconsidered.

Before we dive further into the issue, some definitions are in order. Illinois doesn't have a true sales tax, so when we use the term we are talking about the Retailer's Occupation Tax, the Use Tax, the Service Occupation Tax, the Service Use Tax, and the numerous local taxes authorized by state statute and imposed by local jurisdictions. Like everyone else, we call these taxes, in the aggregate, a sales tax. "General Sales Tax" is a Census Bureau term that distinguishes between sales tax that's imposed on all transactions (groceries and prescription medicine are exceptions) and a tax imposed on selected items. In Illinois, the Chicago Soft Drink Tax and the MPEA Food and Beverage Tax would each be classified as a Selective Sales Tax by the Census Bureau instead of as a General Sales tax.

As Illustrated in **Table 1** and the chart on page 3, when you're looking at per capita state and local sales tax collections, states tend to clump together in the middle of the range, with outliers at either end. Hawaii, for example, has high tax collections per capita. That's because its tax base includes many services and because it has many tourists to pay the taxes, even though the state maintains a relatively low combined state and local tax rate.

<u>What Happened?</u>

The Taxpayers' Federation wondered why Illinois ranked below average in terms of state and local general sales tax burden, particularly given that our combined state and local sales tax rates are relatively high. Although Illinois taxes few services, we tax some items that other states exempt, such as clothing, groceries (albeit at a lower rate), non-prescription drugs, motor fuel, and we tax many business inputs. The Census Bureau's numbers for FY 2012 ($8 billion in state sales tax collections and $1.6 billion in local sales tax collections) appeared significantly different from those reported by the Illinois Department of Revenue ($9.9 billion state and $2.6 billion local), even accounting for fiscal years that did not align and questions about the definition of a "general sales tax."

Given our questions, we asked the Census Bureau to explain why their sales tax collection figures differed from those reported by the State. After some back and forth and with the help of the Illinois Comptroller's staff, we got a prompt explanation and a promise to correct the data. Simply put, some general sales tax revenues had been misidentified and were not showing up as general sales tax in the official census data.

According to Stephen D. Owens, a public sector specialist with the Census Bureau, the 1.25 percent portion of Illinois' 6.25 percent statewide sales tax rate (1 percent goes to either the municipality or the county, depending upon the point of sale and 0.25 percent goes to the county) had been recorded as state to local intergovernmental revenue, but not recorded as a state tax collection. The 1.25 percent will now show up in state general sales tax collections and then as an intergovernmental transfer from the state to local governments.

The Regional Transportation Authority Sales Tax had likewise not been recorded as state or local sales tax receipts, and the RTA tax will now be recorded as a local general sales tax.

The Census Bureau estimated the effect of the change for 2012 as shown in **Table 2**. When 2015 data is released this summer, it will revise general sales tax collections for 2012 through 2014 and post them on its website. The Census Bureau lacks the resources to make adjustments prior to 2012, but will note the change in its files.

TABLE 2. ILLINOIS GENERAL SALES TAXES FOR FY 2012 ($ in Billions)

	Original	Revised	Difference
State	$8.034	$9.634	$1.6
Local	1.611	2.536	0.925
Total	9.645	12.170	2.525

State v. Local Taxes

The Census Bureau uses a rule of three for classifying whether a particular tax is a state or a local tax, looking to 1) who imposes the tax, 2) who administers the tax, and 3) who receives the proceeds from the tax (imposition, administration and retention). The tax is classified as state or local, depending on which level of government has at least two of the three factors. In Illinois, the 1.25 percent local portion of the 6.25 percent tax is imposed by and administered by the state, so is classified as a state tax. The RTA tax is imposed by the RTA and retained by the RTA, so it is classified as a local tax.

After the changes are made, the 6.25 percent will be shown as state general sales tax and all other sales taxes administered by the Department of Revenue--home rule, non-home rule, mass transit, county public safety, county school facility, business district, etc.--will be classified and reported as local taxes.

The Census Bureau's methodology provides consistency across all 50 states, but it is possible to make an argument that Illinois' 6.25 percent general sales tax should be considered a 5 percent state tax and a 1.25 percent local tax. The 1.25 percent tax is administered identically to the various locally imposed taxes and

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distributed to the municipality or county based on the point of sale through a continuing appropriation and without any further action by the Illinois General Assembly or governor.[1]

The Tax Foundation annually computes state and local sales tax rates for each state, weighting the various locally imposed tax rates by population. Illinois' state-plus-weighted-local rate, at 8.64 percent, is the 7th highest. Illinois' 6.25 percent state rate is the 13th highest state rate, but if Illinois' state rate were 5 percent, it would drop to 33rd highest, showing the extent to which the state's overall tax climate is influenced by taxes going to local governments.

The question of how the 1.25 percent sales tax is classified illustrates the significant role that local taxes play in creating Illinois' tax climate and how 50-state comparisons must be done carefully. TFI believes, given differences among states in how they fund and finance various services, the most appropriate measure of tax burden combines state and local taxes. Most taxpayers can't tell and don't care whether a particular tax is state or local, further supporting the notion that the important figure in tax burden analysis is combined state and local taxes.

What's the Effect of the $2.5 Billion Correction?

The $2.5 billion increase in reported general sales tax collections will, as discussed above, increase Illinois' per capita sales tax collections, a commonly-used data point in studies. It will also have effects not immediately obvious, like reducing Illinois' relative reliance on property taxes compared to other states. For FY 2012, the correction increases Illinois' reliance on sales taxes from 14.5 to 17.6 percent, still below the national average of 23 percent. In addition, as sales tax reliance as a percentage of the overall tax picture increases, reliance on other taxes falls, and property taxes drop from 38.4 percent to 37.0 percent. See **Table 3.**

TABLE 3. RELATIVE SHARES OF ILLINOIS STATE & LOCAL TAXES, FY 2012

	Original	Corrected
Property	38.4%	37.0%
Sales	14.5%	17.6%
Excise	13.1%	12.6%
Individual Income	23.3%	22.5%
Corporate Income	5.3%	5.1%
Other	5.4%	5.2%

Source: U.S. Census Bureau

You would expect a $2.5 billion increase in state and local taxes to affect the numerous studies that purport to measure and compare state tax burdens and tax climates among the states. Let's look at a few:

COGFA – The Commission on Government Forecasting and Accountability, the Illinois General Assembly's fiscal forecasting and economic analysis group, produces *Illinois' National Rankings*, a periodic publication that summarizes Illinois' national rankings on a number of tax, economic, and spending factors. Using data from COGFA's 2016 update, on a per capita basis, Illinois total state tax burden would rise roughly $125, from $3,055 to $3,180, and its

[1] The same argument could be made for the Personal Property Tax Replacement Income Tax, a 2.5 percent surcharge added to the Illinois Corporate Income Tax, that pushes the tax rate on corporate taxable income from 5.25 to 7.75 percent. It gets counted as a state tax under the rule of three. However, all proceeds go to local governments and comparisons with states that have personal property taxes get muddied. TFI has a study of the Replacement Tax in the works.

ranking would rise from 15th highest to 13th. Looking at only sales tax revenue, the impact in the COGFA study is slightly larger. The $696 in per capita collections would rise to $821. That increase would bump Illinois' rank from 34th to 29th.

CQ Press State Rankings – The annual publication *State Rankings 2015* included the 2012 Census Bureau data. The increase in state and local taxes per capita would boost Illinois from $749 to $949 and push up its ranking from 39th to 24th.

COST/Ernst & Young annual business tax study –*Total State and Local Business Taxes* uses Census data for its estimates, and Illinois' burden will be increased, but probably not a lot given the size of all business taxes. This study does not rank states but Illinois is in the middle of the range for FY 2015 in business taxes as a percent of Gross State Product.

Tax Foundation, *State-Local Tax Burden Rankings FY 2012* – The Tax Foundation attempts to take into account taxes exported to other states and to attribute taxes paid by vacationers, interstate commuters, and second home residents to their state of residence. The revised Census Bureau data will push their estimate up slightly, but Illinois already has the fifth highest tax burden in the Tax Foundation's rankings.

Tax Foundation, *State Business Tax Climate Index* – The Tax Foundation's widely cited business tax study attributes 23 percent of Illinois' business tax burden to sales tax, but does not use Census Bureau data and instead relies on the average tax rates discussed above. It should not be impacted by the revisions.

Concluding Observations

The pending Census Bureau correction focuses attention on many issues, including:

1 – Illinois state and local sales tax collections and total tax collections are going to look like they jumped up as the $2.5 billion is incorporated into census data and into national comparisons. Researchers and readers should recognize this is because of the correction, not because taxes went up.

2 – Illinois sales tax collections are not as far below the national averages as has appeared in the past. When the "missing" 1.25 percent sales tax and the RTA sales tax are properly reflected in state and local collections, Illinois will move from below average to the middle of the pack.

3 – As sales tax is more accurately reported, the relative contributions of other taxes in the state and local tax system will be reduced. For example, sales tax will comprise more of total state and local tax collections (17.6 vs 14.5 percent), but the property tax share will fall from 38.4 percent to 37.0 percent.

4 – While taxing services makes good tax policy sense, the state's lagging per capita collections is no longer a strong argument for doing so. Because Illinois' combined state and local rates are higher than other states, policy-makers may want to consider reducing rates if and when the base is broadened, in order to maintain Illinois' middle-of-the-road overall sales tax burden.

5 – All interstate tax burden comparisons should be taken for what they are--estimates--and not as authoritative sources that definitively make a point. Taxes are complicated and nuanced, and comparisons among states are exponentially more so.

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