TAX FACTS

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Expanding the Base of Illinois' Sales Tax to Consumer Services will Both Modernize State Tax Policy and Help Stabilize Revenue

By The Center for Tax and Budget Accountability and the Taxpayers' Federation of Illinois

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1. INTRODUCTION

According to the Illinois Comptroller, the state has run a deficit in its General Fund every year since at least 1991.[1] The causes of these annual deficits vary, as do the potential solutions, but the data make one thing clear—antiquated tax policy is one of the significant contributors to Illinois' long term fiscal shortcomings. Unfortunately, reforming tax policy is both difficult and complex. It is difficult because tax policy has very much become the third rail of politics. It is complex because it involves designing a revenue system that comports with the four, core principles of sound tax policy in a modern economy[2] —that taxes be **fair** to taxpayers, be **responsive** to the economy, generate some **stable** revenue even during poor economic cycles, and be **efficient,** in that tax policy should not distort significant private sector activity—which should be primarily market driven. The complexity of tax policy is exacerbated, because no one type of tax satisfies each of these

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

This issue of Tax Facts presents an overview of the taxation of consumer services, a joint project of TFI and the Center for Tax and Budget Accountability. (Many thanks to Ralph Martire, Amanda Kass, and Bobby Otter of CTBA for their hard work.) The Taxpayers' Federation and CTBA do not always see eye to eye, but both organizations agree that taxing consumer services comports with good tax policy.

The study makes several points:

- Illinois taxes fewer services than most other states.
- Economic growth has been stronger in the service sector than in the durable goods sector.
- There are tax policy arguments in favor of taxing consumer services; business-to-business services and professional services, however, should not be taxed.

Our second article is an explanation from Rob Ross, TFI's research assistant, of how countries structure their Value Added Taxes (VATs) to avoid pyramiding, accomplishing the same goal that excluding business-to-business services accomplishes under a sales tax.

The final piece in this issue points out that, although broadening the tax base may make tax policy sense, there are significant administrative, logistical, and educational hurdles. Illinois cannot expand the sales tax base to consumer services without first completing a substantial amount of work.

principles. So the challenge becomes creating the proper mix of different taxes, each of which have very different roles to play.

For instance, generally speaking income taxes bring both fairness and responsiveness to a state's fiscal system, while sales taxes are supposed to bring stability. (Property taxes are another stable revenue source, but for the most part are local, rather than state-based revenue sources). In effect, designing sound tax policy is much like designing a diversified, long-term investment strategy. Just as a prudent investor wants a variety of holdings with varying degrees of risk, a sustainable, sound state tax system utilizes a mixture of different taxes, each of which must be appropriately designed to play its desired fiscal role.

Over the years, numerous changes to Illinois' tax policy have been offered to address—at least in part—the state's fiscal shortcomings. Rarely, however, have those suggestions been designed to satisfy the principles of sound taxation in a modern economy. However, Illinois' newly elected Governor, Bruce Rauner, has stated, both during the campaign and in his recent state-of-the-state address that expanding the base of Illinois' sales tax to include more services would help modernize the Illinois sales tax to work better in today's economy. One role of a state sales tax is to generate stable revenue for the state's fiscal system, so the question then becomes whether expanding the sales tax base in Illinois would make it more likely that the sales tax will perform this intended function. The short answer as it turns out is yes—and the reasons for that are delineated below.

2. THE BASICS OF SOUND TAX POLICY

Before analyzing whether expanding the base of the Illinois sales tax is appropriate, a short overview of what actually constitutes sound tax policy would be helpful. Whether a state has a sound tax system depends on a number of factors: if it has a proper mix of tax revenue sources, the base of each tax, and how tax burden is distributed among taxpayers, for example. From a good-government standpoint, taxes should also be predictable and transparent. Predictability enhances a taxpayer's ability to accurately budget for likely tax liabilities, while transparency reduces the risk of taxpayer error and enhances confidence in the system. From the standpoint of fiscal functionality, that is, whether tax policy will sustainably generate revenue to fund spending on government services over time, tax policy should be fair, responsive, stable, and efficient.[3]

Fairness. Fairness is measured in two ways: "horizontally", comparing the tax burden of different taxpayers with similar income levels, and "vertically," comparing the tax burden of taxpayers across different income levels.[4]

Responsiveness. A responsive tax is assessed in a way that responds to how growth is actually realized and distributed in the economy. That means taxes should be imposed where economic activity is significant and where it is increasing over time. A responsive tax generates the fiscal capacity for revenue growth to keep pace with the inflationary cost growth of providing services over time, since it responds to growing economic activity. But such a tax is also volatile, and hence needs to be supported by a more stable revenue source.

Stability. Every tax system should have a stable revenue source that maintains adequate base revenue generation even during poor economic cycles. Stability is also helpful to taxpayers as it provides a level of predictability regarding what they will owe in taxes.

Efficiency. An efficient tax system is one that has minimal impact on important economic decisions private taxpayers make, like where to purchase a home or locate a business.[5] Those key economic decisions should be driven primarily by market factors, not the government's imposition of taxes.

As noted previously, different taxes play different roles in meeting the principles of a sound tax system. Because sales taxes can be designed to be significantly less volatile than personal and corporate income taxes,[6] a well-designed sales tax should lower the overall volatility of state revenues, thus providing a more stable revenue source than the income tax.[7]

For a sales tax to play its role of generating stable revenue for a fiscal system, it needs to apply broadly to most transactions that occur in the consumer economy. The reasons for this are easy to understand. First, consumer spending is the largest segment of both the nation's and Illinois' respective economies, accounting for nearly 70 percent of all economic activity.[8] Second, consumer spending usually does not decline substantially—even during major economic downturns. For instance, during the Great Recession, consumer spending remained relatively constant, with real personal consumption expenditures declining by less than one percent from 2007 through 2010.[9] Hence, if a sales tax base broadly applies to most transactions in the consumer economy, that sales tax will have the capacity to provide some stability to a state's fiscal system, even when other more volatile/responsive revenues are declining rapidly. In addition, a broadly applicable sales tax is efficient—it does not distort consumer decision-making by exempting, and thereby favoring, one business sector over another.

3. SALES TAX OVERVIEW

3.1 Illinois Sales Tax in Context

Currently, Illinois is one of 45 states that impose a general sales tax.[10] A sales tax is usually assessed at a specified percentage (say 5 percent or 6 percent) of the final purchase price of a retail good or service. Sales taxes are typically charged on the final retail sales transaction involving the end-user, and generally do not cover many business-to-business transactions, nor professional services.[11] If the sale of a product or service is subject to the applicable sales tax, then that product or service is in the "base" of said sales tax.

Nationwide, states did not begin implementing sales taxes until the 1930s. Prior to that time, property taxes were the primary revenue source for both state and local governments. However, the significant decline in property values that occurred during the Great Depression compelled governments to seek new sources of revenue to fund current services—and assessing a sales tax was identified as one-way to help mitigate the loss of property tax revenue. In 1932, Mississippi became the first state to adopt a sales tax.[12] Shortly thereafter, in 1933, Illinois lawmakers adopted a temporary sales tax, which was made permanent in 1935.[13]

While it is commonly referred to as a singular tax, the Illinois sales tax is actually created under several different sections of the state tax code. The "Retailers' Occupation Tax" is assessed on the gross receipts retailers collect from selling tangible property in Illinois.[14] This is what most people think of as the sales tax in Illinois. Then there is the "Use Tax," which is assessed on consumers who make out of state purchases and use that property in Illinois.[15] So, for instance, online purchases an individual makes for things like books, razor blades, and pencils are subject to the Illinois Use Tax, even if the out-of-state retailer selling those items did not add the Illinois tax to the final bill. In this case, the purchaser has the responsibility to compute how much tax is owed to Illinois and then has to remit payment thereof to the state.

Finally, there are the Illinois' "Service Occupation Tax" and the "Service Use Tax," (the "SOT" and "SUT") which interestingly are not imposed on services, making the titles of the acts quite a misnomer. Instead, the SOT and SUT impose tax on tangible property that is sold or acquired incident to purchasing a service.[16] For example, when a car is repaired, tax applies only to the parts included in the repair, not to the cost of labor.

In this paper, we conform to common practice and use the term "sales tax" to refer collectively to the four taxes described above.

3.2 Illinois' Sales Tax Rate

The sales tax rate for most goods at the state level in Illinois is 5 percent. However, Illinois' state sales tax rate is usually identified as 6.25 percent. This is because starting in 1990, the state rate of 5 percent was combined with a local sales tax rate of 1.25 percent.[17] The 1.25% local rate was added in 1990 to replace other stand-alone local taxes. Hence, the 6.25 percent sales tax rate is actually made up of a 5 percent state sales tax rate and 1.25 standard local government sales tax rate. **Figure 1** shows the state sales tax rate history in Illinois.

FIGURE 1. ILLINOIS STATE SALES TAX RATE HISTORY[18]

Effective Date	Rate
July 1, 1933	2.00%
July 1, 1935	3.00%
July 1, 1941	2.00%
July 1, 1955	2.50%
July 1, 1959	3.00%
July 1, 1961	3.50%
July 1, 1967	4.25%
October 1, 1969	4.00%
January 1, 1984-Current	5.00%[19]

Source: COGFA, Sales Taxes in Illinois (Springfield, IL: May 2010), 2.

In addition to the state sales tax rate of 5 percent and standard local rate of 1.25 percent, local units of government in Illinois may now impose additional levies, increasing the total sales tax rate that is assessed in their respective jurisdictions.[20] The ultimate sales tax rate customers pay in any given community in Illinois, then, is the combination of the state and all applicable local tax rates. For example, on top of the 5 percent state rate and the 1.25 percent standard local government rate, the City of Chicago imposes an additional 1.25 percent sales tax, Cook County imposes an additional 0.75 percent sales tax, and the Regional Transportation Authority imposes an additional 1 percent sales tax. Thus, the total sales tax rate for most purchases made in Chicago is 9.25 percent.[21]

Most goods sold in most areas of Illinois are subject to the total combined rate of all applicable taxes. However, the state collects only a 1 percent local sales tax on food[22] and medicine,[23] and distributes all proceeds from that tax to local governments.

3.2 State Sales Tax Rate Comparison

Of the 45 states with a state sales tax, only three have a standard state and local combined rate like Illinois.[24] As such, when comparing state sales tax rates it is important to exclude any local rates to ensure an apples-to-apples comparison. It is also important to note that this analysis compares state sales tax rates, and not sales tax burden. Tax burden is not examined because this report is focused on the sales tax from the perspective of the state's fiscal system.

FIGURE 2. 2015 STATE LEVEL ONLY SALES TAX RATE COMPARISON RANKED HIGHEST TO LOWEST	
ILLINOIS: 5%	
Neighbor States	**Other Large States**
Indiana: 7.000%	California:[27] 6.50%
Iowa: 6.000%	Texas: 6.25%
Kentucky: 6.000%	Florida: 6.00%
Michigan: 6.000%	Pennsylvania: 6.00%
Wisconsin: 5.000%	Ohio: 5.75%
Missouri: 4.225%	New York: 4.00%

Source: CTBA analysis; "State Sales Taxes--Food and Drug Exemption," Federation of Tax Administrators, accessed January 2015, http://www.taxadmin.org/fta/rate/vendors.pdf

Illinois' state sales tax rate of 5 percent is below the national average of 5.5 percent.[25] As of January 2015, state sales tax rates range from a low of 2.9 percent in Colorado to a high of 6.5 percent in California.[26] **Figure 2** compares Illinois' state sales tax rate to the rates in neighboring and other large states.

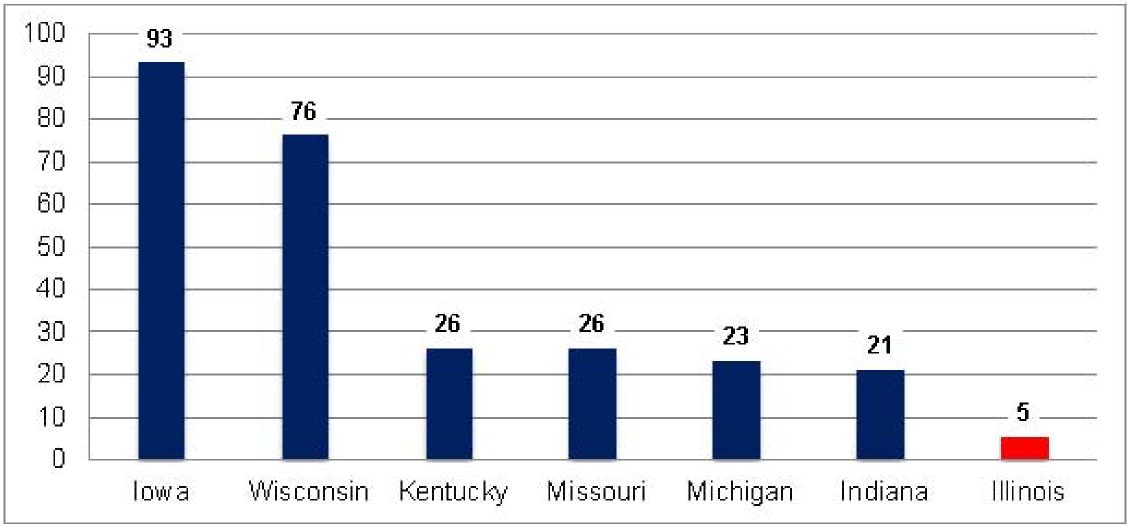
Like Illinois, many states, including several of those listed in Figure 2, allow local governments to impose sales taxes in addition to the state rate. As a result, just as in Illinois, the total sales tax rate on purchases in states like Missouri, Texas, and New York can be nearly double the state-only rate. Again, because this report is focused on the state's fiscal system, those additional tax rates are not included in our analysis. We recognize, however, that to the taxpayer, the local-state distinction is largely irrelevant and only the total amount of tax paid matters.

3.4 Illinois' Sales Tax Base

As indicated previously, the "base" of a sales tax is simply the basket of items and services that the tax applies to when sold. Those items included in the base of Illinois' sales tax are defined by statute (the Retailers' Occupation Tax, Use Tax, the SOT, and the SUT). In general, Illinois' sales tax applies to goods (like clothing and furniture) and not services (like pet grooming, health clubs, and haircuts).

Creating an exhaustive list of services, identifying which ones Illinois currently does tax, and comparing Illinois' sales tax base to other states is difficult because of a lack of comprehensive data. Currently, a 2007 report released by the Federation of Tax Administrators (**FTA**) is one—if not the only—resource that attempts to compile an all-inclusive list of what services states tax. However, the FTA survey is limited in several ways. First, the data in the FTA survey is self-reported by each state, and as such, each of the respondents could interpret the survey questions differently. Second, the survey relies on the North American Industry Classification System (**NAICS**), which is a system to classify businesses into different industry groups. As such, the survey identifies what service industries are at least partially subject to taxation in each state, but it does not necessarily identify specific services subject to taxation. The FTA plans to administer a new survey that will identify the actual services taxed in each state. Despite the limitations of the FTA's 2007 survey, it offers the best available data to gain a general understanding of sales tax base differences among states.

FIGURE. 3. NUMBER OF SERVICE INDUSTRIES TAXED UNDER GENERAL SALES TAX[30]



Source: Analysis of Federation of Tax Administrators, Survey of Services Taxation (Washington, DC: July 2008), http://www.taxadmin.org/fta/pub/services/btn/0708.html.

Out of 168 service industries that were included in FTA's survey, Illinois' general sales tax is only applicable to five.[28] This makes Illinois an outlier nationally. Among the 45 states with a general sales tax, the average number of service industries taxed is 51.[29] **Figure 3** shows the number of service industries identified as subject to the general sales tax in Illinois and in its neighboring states.

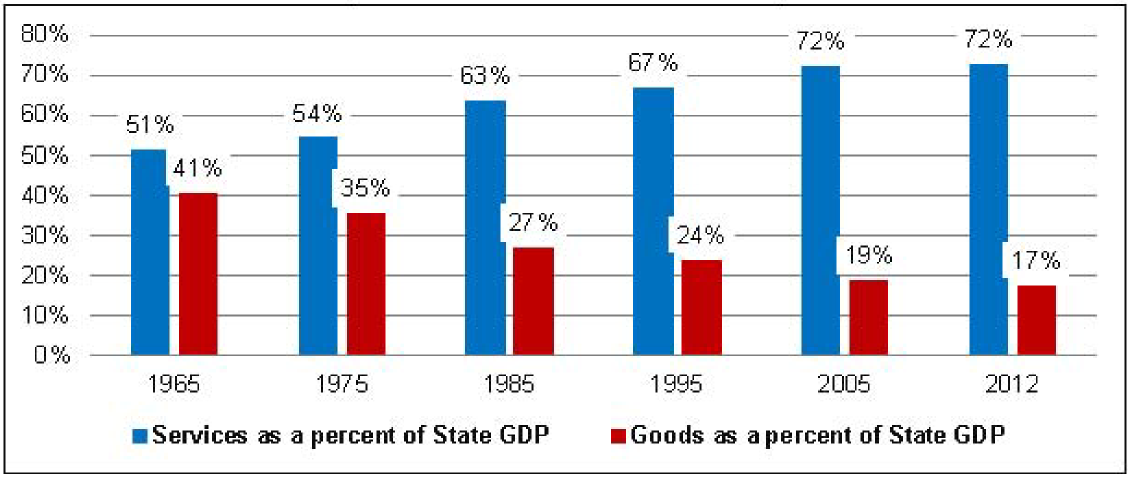
As highlighted by Figure 3, Illinois' sales tax applies to fewer service industries than do the sales taxes in all of Illinois' neighboring states. Nationally, Illinois ranked 45th (out of 45) in the number of service industries identified as subject to its general sales tax.[31] Because Illinois does not apply its sales tax to most services, it has what is considered a narrow sales tax base. This is problematic because research shows that a narrow–based tax is more volatile than a broad-based one.[32] Volatility is not desirable in a sales tax, which is supposed to generate stable revenue for a fiscal system. Hence, broadening Illinois' sales tax base to include more services than are currently taxed should decrease this volatility. This, in turn, should enable the sales tax to do a better job of generating stable revenue for the Illinois fiscal system.

In fact, the data make it quite clear that Illinois' exclusion of most consumer services from its sales tax base diminishes the ability of the Illinois sales tax to perform the function of helping to stabilize revenue generation. Consider, for instance, that in 1965, the sale of services accounted for 51 percent of the total Illinois economy, while the sale of goods accounted for 41 percent. Over the next half century, the Illinois economy greatly changed. By 2012, the sale of services increased to represent 72 percent of the state's economy, while the sale of goods declined significantly, accounting for just 17 percent of the

Illinois' economy.[33] Put another way, the base of the Illinois' sales tax lost more than half of its value as a share of Illinois' economy over the last four decades.

Figure 4 illustrates how dramatic this shift from goods to services in the Illinois economy has been.

FIGURE 4. REVENUES OF GOODS AND SERVICES AS A PERCENT OF GROSS DOMESTIC PRODUCT: ILLINOIS (SIC 1965-1995, NAICS: 2005-2012)

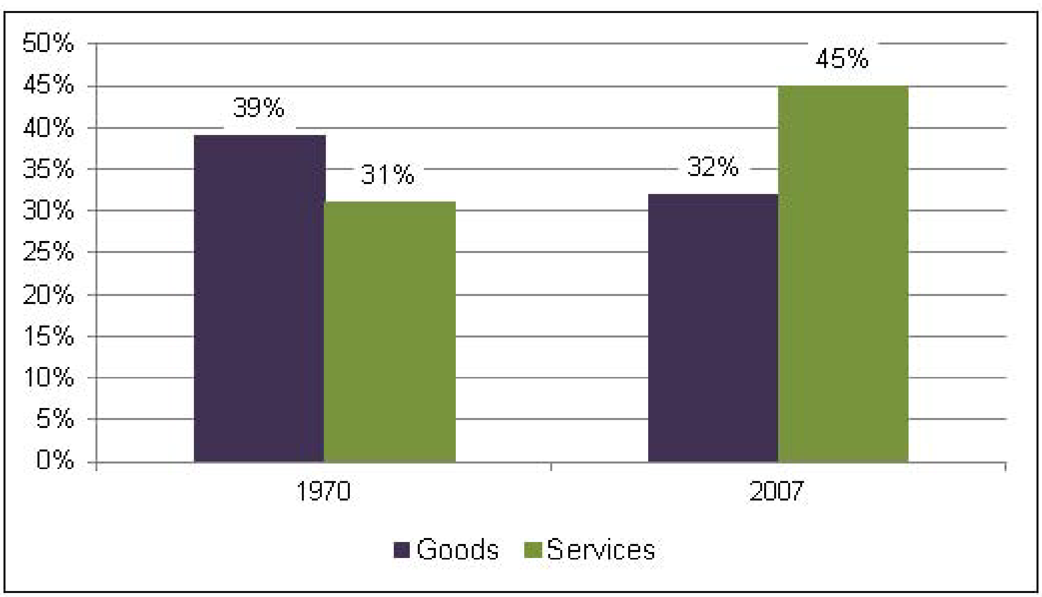


Source: Bureau of Economic Analysis, Gross Domestic Product by State comparing Private goods-producing industries and Private services-providing industries.[34]

Excluding most services from its sales tax base has created a fiscal mismatch between the actual Illinois economy and the portion of the economy taxed to fund public services.

Just as Illinois' overall economy has changed dramatically, as shown in Figure 4, national household consumption patterns have also shifted over time. Services now take up a greater share of household consumption than goods, which is a major change from the 1970s, as shown in **Figure 5**.

FIGURE 5. NATIONAL HOUSEHOLD CONSUMPTION: GOODS VERSUS SERVICES



Source: Michael Mazerov, *Expanding the Sales Taxation of Services: Options and Issues* (Washington, DC: Center for Budget and Policy Priorities, July 2009). v.

While Illinois' economic base and household consumption have shifted dramatically over the last three decades from goods to services, there has been no corresponding change in Illinois' tax structure. Simply put, the Illinois sales tax base has not been adjusted to reflect either changing consumption patterns or economic patterns. By leaving the majority of the largest and fastest growing sector of the state's economy out of its sales tax base, Illinois has effectively ensured that its sales tax cannot perform the stability function needed for its fiscal system to be sound.

This has meant that revenue generation from the state sales tax is more volatile than it should be. As illustrated in **Figure 6 on page 10**, Illinois' sales tax revenue declined after both the mild recession in the early 2000s and the Great Recession of 2008.

Compare that to the relative lack of volatility—or put another way, relative stability—of the Wisconsin sales tax over the 1995-2013 sequence. As shown in **Figure 7 on page 10**, Wisconsin, which has a much broader base for its state sales tax than Illinois, has seen its sales tax better perform the needed stability function. Tax collections dropped some, but not as dramatically as Illinois', during the economic downturns.

Expanding the state's sales tax base to include more services would create a more stable revenue source for Illinois, and will better align its fiscal system with today's economy.

3.5 What Type of Expansion is Appropriate?

To modernize its sales tax, Illinois should expand its base to include consumer services, like pet grooming, haircuts, country club membership, health clubs, and lawn care.

The focus on consumer services is intentional. There are a number of service industries that should not be included in the state's sales tax base for a variety of reasons. For instance, regardless of the service, business-to-business transactions should not be taxed, because taxing such transactions creates economic distortions and inefficiencies. Indeed, taxing business-to-business transactions typically results in "tax pyramiding," which occurs when essentially one economic transaction is taxed multiple times during production and distribution, rather than just once upon final sale to the end-user. Tax pyramiding artificially increases the cost of a product or service as it flows through the economy, by taxing various stages of production. **Figure 8 on page 11** provides a very simple illustration of the effect of tax pyramiding.

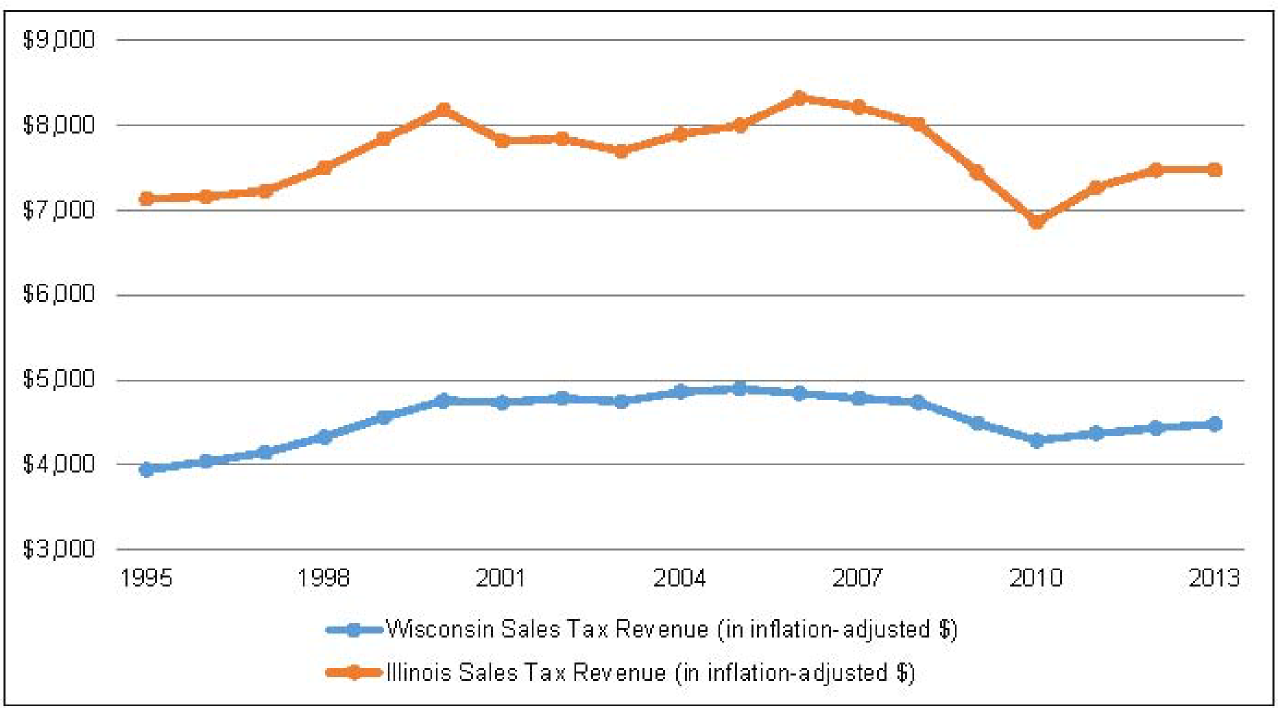
In a properly designed sales tax system, only the final stage of this integrated transaction, the sale to the final consumer (highlighted in red in Figure 8), would be taxed, generating $20 in state revenue. However, if each stage of the business-to-business segments of this transaction were taxed, rather than imposing the appropriate $20 in taxes, the state would effectively impose $62.50 in taxes, or more than three times as much. Worse yet, the total amount of tax paid is buried and non-transparent.

Moreover, the above scenario understates the impact of this tax pyramiding. That is because for the most part, the sales tax imposed on one stage of production will be passed on as part of the price of the item as it flows to the next stage of production. This is not only highly inefficient, but results in a tax-on-tax scenario, with the final

FIGURE 6. ILLINOIS' GENERAL FUND SALES TAX REVENUE, ADJUSTED FOR INFLATION

Source: COGFA, *Illinois Revenue Volatility Study: Public Act 98 – 0682*, (Springfield, IL: December 31, 2014), 13.[35]

FIGURE 7. COMPARISON OF ILLINOIS AND WISCONSIN STATE LEVEL SALES TAX REVENUE, ADJUSTED FOR INFLATION



Sources: COGFA, *Illinois Revenue Volatility Study: Public Act 98 – 0682*, (Springfield, IL: December 31, 2014), 13; Wisconsin data from the U. S. Census State Government Tax Collections, https://www.census.gov/govs/statetax/index.html.[36]

FIGURE 8. EXAMPLE OF TAX PYRAMIDING EFFECT, USING A 5% RATE

Producer sells $100 worth of raw materials to a Manufacturer: $5 tax	→	Manufacturer adds value and sells $200 product to an Integrator: $10 tax	→	Integrator adds value and sells $250 product to a wholesaler: $12.5 tax	→	Wholesaler adds value and sells $300 product to a retailer: $15 tax	→	Retailer adds value and sells $400 product to consumer: $20 tax

consumer ultimately paying the lion's share of the artificial cost tax pyramiding creates.[37] It also artificially inflates the price of a final product or service that has most of its inputs in Illinois, because other states for the most part limit their sales tax bases appropriately to the final retail sale to a consumer. Hence, an over-expansion of the sales tax base to include business-to-business transactions would hurt both businesses and consumers.

Also, taxing business-to-business transactions can incentivize businesses to integrate vertically as a tax avoidance strategy. Vertical integration occurs when a business chooses to produce products or services in-house that it once purchased from a third-party. A business that decides to create a new marketing department to do all of its advertising would be an example of vertical integration. This can ultimately lead to a business becoming less efficient,[38] and discriminates against small businesses, because larger businesses can vertically integrate to reduce their tax costs (and therefore reduce the prices charged their customers or increase their profits) more easily than their smaller competitors.[39] A tax structure that does not minimize the taxes on business-to-business transactions, then, fails the fourth principle of sound tax policy, efficiency, by distorting business decisions and unnecessarily favoring one party over another.[40]

Finally, the majority of professional services should also remain out of the Illinois sales tax base. Currently, most states do not tax professional services. Of the 45 states with a general sales tax, only six have sales taxes that apply to *any* professional service industry.[41] Illinois simply should not go from being a national tax outlier by having too narrow of a base, to being an outlier for having too broad of a base. There are other, administrative issues unique to taxing professional services that make doing so more complicated and cumbersome than other services,

Illinois Tax Facts

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such as determining which local jurisdiction taxes apply, or whether the service is taxable in Illinois at all. These issues are very difficult. The focus ultimately should be on getting tax policy right.

Alternatively, this base-broadening could be accompanied by a lowering of the rates, so that tax revenues are unchanged, but will be more aligned with the state's economy and achieve the other tax policy improvements described in this report.[45]

FIGURE 9. ESTIMATED FY2014 STATE SALES TAX REVENUE FROM SALES TAX EXPANSION ($ MILLIONS)

State Sales Tax Rate	Estimated FY2014 Revenue	Estimated FY2014 Revenue with Expansion	Revenue Increase/ (Decrease) from Estimated FY2014 Revenue of the Expansion
5%	$7,973	$10,078	$2,105

Source: Estimate based on Commission on Government Forecasting and Accountability, *Service Taxes 2011 Update* (Springfield, IL: April 2011), 13-14. FY2011 data from COGFA adjusted for inflation using the Midwest Consumer Price Index, as reported by the Bureau of Labor Statistics.

4. FISCAL IMPACT OF SALES TAX EXPANSION IN ILLINOIS

The Governor's Office of Management and Budget estimated total revenue from the 5 percent state sales tax rate to be $7.97 billion for fiscal year (**FY**) 2014.[42] To evaluate the impact a sales tax expansion could possibly have, this report uses estimates produced by the Commission on Government Forecasting and Accountability (**COGFA**) in 2011 and adjusted those estimates to account for inflation.[43] Based on COGFA's analysis, an estimated $2.105 billion in additional revenue could be generated if the sales tax base was expanded to include primarily consumer service industries while excluding business-to-business transactions and professional services, as shown in **Figure 9**.[44] (A listing of the services identified by COGFA is contained in Appendix A to this report, available at iltaxwatch.org and ctbaonline.org.)

In addition to providing increased revenue for the state (or enabling a rate reduction), a sales tax base expansion would also generate revenue for local governments, taking some pressure off the property tax (or allowing local governments to lower their sales tax rates). Indeed, such an expansion would generate approximately $526 million in revenue for those local governments which impose just the standard, 1.25 percent sales tax rate, as illustrated in **Figure 10 on page 13**. Local governments that impose a sales tax rate above the base 1.25 percent would see greater revenue increases.

5. CONCLUSION

Increasing state tax revenue by expanding the sales tax base to include services would be especially timely, because the temporary state income tax rate increases enacted in 2011 began phasing down on January 1, 2015, halfway through the current fiscal year, FY2015.[46] Those rate reductions caused the state to realize a year-to-year loss of an estimated $1.3 billion in recurring General Fund revenue from FY2014 levels.[47]

Additionally, there may currently be some political will to consider expanding the state's sales tax base. As noted previously, during Governor Bruce Rauner's campaign in 2014 and more recently in his 2015 State of the State address, he proposed expanding the state's sales tax base. As such, Governor Rauner expressed a willingness to changing the sales tax in Illinois so that it better reflects the modern economy.

which collectively account for $9 out of every $10 of General Fund spending. Consider that, appropriations for current year services in FY2015 are $25 billion,[49] so reducing that spending to accommodate a $3.4 billion year-to-year loss in revenue could result in 14 percent cuts across the board. As a result (and also because of the change in party control in our Executive Branch), this year's budget deliberations will be more far-reaching than usual, and structural tax reform (whether it is accompanied by additional revenue or a rate reduction) can be a vital tool in transforming Illinois' fiscal situation for next year, and into the future.

FIGURE 10. ESTIMATED FY2014 LOCAL SALES TAX REVENUE FROM SALES TAX EXPANSION ($ MILLIONS)

Local Sales Tax Rate	Estimated FY2014 Revenue	Estimated FY2014 Revenue with Expansion	Revenue Increase/ (Decrease) from Estimated FY2014 Revenue of the Expansion
1.25%	$1,993	$2,519	$526

Source: Estimate based on Commission on Government Forecasting and Accountability, *Service Taxes 2011 Update* (Springfield, IL: April 2011), 13-14. FY2011 data from COGFA adjusted for inflation using the Midwest Consumer Price Index, as reported by the Bureau of Labor Statistics.

As difficult as the revenue loss from FY2014 to FY2015 will be to absorb, the full impact of the income tax phasedown will not be felt until FY2016, when the reduced income tax rates will be in effect for the full fiscal year. As a result, FY2016 is estimated to have $3.4 billion less in General Fund revenue than FY2015.[48] That large of a revenue loss would require material cuts to spending on the core services of education, healthcare, human services, and public safety,

Expanding the Illinois sales tax base to include services is not a silver bullet that will solve the fiscal dilemma facing the state, but it could be an important step. Whether the additional revenues raised are kept by the state, or whether the total tax burden is maintained by lowering the rates, such a change will help improve the long-term stability of the state's fiscal system because it would allow the sales tax to comport with both the modern economy and the principles of sound tax policy.

ENDNOTES

[1] http://www.ioc.state.il.us/index.cfm/fiscal-condition/gaap-fund-balance/ and using Generally Accepted Accounting Principles (GAAP)

[2] Allan, Ian J. "Evaluating Alternative Revenue Sources" Government Finance Research Center, Government Finance Officers Association, January 1992.

[3] Allan, Ian J. "Evaluating Alternative Revenue Sources" Government Finance Research Center, Government Finance Officers Association, January 1992.

[4] Cordes, Joseph J. 1999. "Horizontal Equity." The Encyclopedia of Taxation and Tax Policy. Urban Institute Press.

[5] Allan, Ian J. "Evaluating Alternative Revenue Sources" Government Finance Research Center, Government Finance Officers Association, January 1992.

[6] COGFA, *Illinois Revenue Volatility Study: Public Act 98 – 0682*, (Springfield, IL: December 31, 2014), 4.

[7] COGFA, *Illinois Revenue Volatility Study: Public Act 98 – 0682*, (Springfield, IL: December 31, 2014), 4.

[8] U.S. Bureau of Labor Statistics, *Consumer Spending and U.S. employment from the 2007-2009 recession through 2022* (Washington, DC: October 2014), 7.

[9] U.S. Bureau of Labor Statistics, *Consumer Spending and U.S. employment from the 2007-2009 recession through 2022* (Washington, DC: October 2014), 5.

[10] "State Sales Taxes--Food and Drug Exemptions (January 1, 2014)," Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/vendors.pdf. The states that do not impose a sales tax are: Alaska, Delaware, Montana, New Hampshire, and Oregon. In Alaska and Montana, however, local governments are allowed to impose their own sales taxes.

[11] Some business-to-business transactions are taxed, although from a policy perspective they should all be exempt. It can be difficult differentiating whether certain purchases of products or services are typically made in a business-to-business environment, or are more of a consumer-type interaction.

[12] "State Sales and Use Taxes 2013," National Conference of State Legislatures, accessed October 13, 2014, http://www.ncsl.org/research/fiscal-policy/state-sales-and-use-taxes-2013.aspx

[13] COGFA, *Sales Taxes in Illinois* (Springfield, IL: May 2010), 2.

[14] 35 ILCS 120/1 to 120/14

[15] 35ILCS 105/1 to 105/22

[16] 35 ILCS 110/1 to 110/21 and 35 ILCS 115/1 to 115/21

[17] IDOR, *Annual Report of Collections and Distributions: Fiscal Years 2011 and 2012* (Springfield, IL), 22.

[18] Rates do not include any rates imposed by municipalities or counties.

[19] Starting on January 1, 1990, the state sales tax rate of 5 percent was combined with a standard local sales tax rate of 1.25 percent. Today, the state sales tax rate in Illinois is often identified as 6.25 percent.

[20] Including, but not limited to, the following: 55 ILCS 5/5-1006 (Home Rule County Retailers' Occupation Tax); 55 ILCS 5/5-1007 (Home Rule County Service Occupation Tax); 65 ILCS 5/8-11-1 (Home Rule Municipal Retailers' Occupation Tax); 65 ILCS 5/8-11-5 (Home Rule Municipal Service Occupation Tax); 65 ILCS 5/8-11-1.3 (Non-home Rule Municipal Retailers' Occupation Tax); and, 65 ILCS 5/8-11-1.4 (Non-home Rule Municipal Occupation Tax).

[21] "Illinois Tax Rate Finder," Illinois Department of Revenue, accessed August 2014, "https://www.revenue.state.il.us/app/trii/."

[22] Only food that is not consumed at the site it is purchased at—for example, groceries—is subject to the 1 percent tax. Restaurant meals are subject to the full tax.

[23] This includes prescription and over the counter medications, as well as medical devices.

[24] The other three states with a standard combined state and local sales tax are: California, Utah, and Virginia.

[25] "State Sales Tax Rates and Vendor Discounts," Federation of Tax Administrators, accessed April 27, 2015 http://www.taxadmin.org/fta/rate/vendors.pdf

[26] "State Sales Taxes--Food and Drug Exemptions," Federation of Tax Administrators, accessed August 27, 2014 http://www.taxadmin.org/fta/rate/vendors.pdf While the FTA lists California's rate as 7.5 percent, that rate is actually a combination of a 6.5 percent state rate and 1 percent local rate.

[27] Like Illinois, California has an additional local portion of the sales tax which increases it 1 percentage point. See the California State Board of Equalization (http://www.boe.ca.gov/news/sp111500att.htm) for more information.

[28] An additional 12 service industries in Illinois are subject to excise taxes.

[29] Figure is just for industries subject to a general sales tax. CTBA analysis of Federation of Tax Administrators, Survey of Services Taxation (Washington, DC: July 2008), http://www.taxadmin.org/fta/pub/services/btn/0708.html.

[30] Data includes service industries that may be subject to excise taxes.

[31] Note this comparison is only for industries taxed under states' general sales taxes. Analysis of Federation of Tax Administrators, Survey of Services Taxation (Washington, DC: July 2008), http://www.taxadmin.org/fta/pub/services/btn/0708.html.

[32] COGFA, *Illinois Revenue Volatility Study: Public Act 98 – 0682*, (Springfield, IL: December 31, 2014), 65.

[33] Some academics argue that it is precisely because services have not been taxed that allowed that sector of the economy to grow so rapidly. That theory, however, is beyond the scope of this report, and in any event, services now make up 72 percent of Illinois' GDP.

[34] For 2000-2012, the Bureau of Economic Analysis classified industries into the Private goods-producing industries and Private services-providing industries categories, but for 1963-1999, CTBA classified industries into those categories. CTBA's Classification based on BEA definition of private good-producing industries and private services-producing industries. See page 9 of Industry Economic Accounts: Results of the Comprehensive Revision Revised Statistics for 1997-2012 (Feb 2014), http://www.bea.gov/scb/pdf/2014/02%20February/0214_industry%20economic%20accounts.pdf

[35] All dollars are in 2014 dollars, inflation adjustment done using the seasonally adjusted Consumer Price Index.

[36] All dollars are in 2014 dollars, inflation adjustment done using the seasonally adjusted Consumer Price Index.

[37] William Fox and LeAnn Luna, "How Broad Should State Sales Tax Bases Be? A review of the Empirical Literature." State Tax Notes (August 22, 2006):

[38] Andrew Chamberlain and Patrick Flenor, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes." *State Tax Notes* (February 19, 2007): 457-467.

[39] William Fox and LeAnn Luna, "How Broad Should State Sales Tax Bases Be? A review of the Empirical Literature." *State Tax Notes* (August 22, 2006): 639.

[40] There are practical difficulties associated with exempting business-to-business transactions. Does the government identify the services that are usually purchased by consumers and only tax them by taxing all services but allowing for an exemption based on the purchaser's status (like charitable organizations are exempted today), or does the government follow the approach used in taxing goods and only exempt those services that are resold or are readily identifiable in or associated with the end-product?

[41] CTBA analysis of Federation of Tax Administrators, Survey of Services Taxation (Washington, DC: July 2008), http://www.taxadmin.org/fta/pub/services/btn/0708.html. The six states that have at least some professional services included in their sales tax base are: Hawaii, New Jersey, South Dakota, Texas, Washington, and Wisconsin.

[42] Figure is for total state sales tax revenue. Approximately 95 percent of state sales tax revenue goes into the General Fund. Data source: GOMB, *Illinois State Budget: Fiscal Year 2015* (Springfield, IL: March 26, 2014), CH 2-71.

[43] COGFA's revenue estimates rely on NAICS codes, which as discussed previously in this report are problematic. In 2012 the Center on Budget Policy and Priorities (**CBPP**) published a report that explained a new methodology that could be done using economic census data to estimate the impact of a sales tax expansion to include services—*Using Economic Census Data to Estimate the Revenue Impact of Taxing Services* (Washington, DC: February 15, 2012). While the CBPP methodology may provide a more accurate revenue estimate, it also poses some challenges. The primary difficulty is that estimating potential revenue from taxing all services currently not taxed in Illinois would require careful examination of tens of thousands of product line data. Nevertheless, using the CBPP's methodology may be appropriate for evaluating the fiscal impact of a legislative proposal that identifies specific services to be included in Illinois' sales tax. The Illinois Department of Revenue is ideally suited to perform this task, and hopefully will do so in the near future, so that more current and service-specific estimates can be available to the state's policy-makers.

[44] The information used to identify service industries and the potential revenue impact from expanding the sales tax base to include services produced by those industries is based off a 2011 report done by COGFA: COGFA, *Service Taxes: 2011 Update* (Springfield, IL: April 2011). In that report, COGFA estimated revenue that could be generated by expanding Illinois' sales tax to include 92 service industries; however, a number of service industries were professional services or had no revenue estimate, and as such were excluded from this report.

[45] Reasonable people can and do differ over how much total revenue the state should collect and spend. Nevertheless, even those who disagree over the proper level of state revenues and spending, such as the authors of this report, can and do agree over how those taxes should be collected.

[46] Under TABSA, the personal income tax rate declined from 5 percent to 3.75 percent, and the corporate income tax rate dropped from 7 percent to 5.25 percent on January 1, 2015, halfway through the fiscal year.

[47] This is based on estimated FY2014 total General Fund revenue of $36.7 billion and an updated FY2015 revenue estimate of $35.42 billion (including a revenue estimate of $34.10 from COGFA, *FY 2016 Economic Forecast and Revenue Estimate and FY 2015 Revenue Update* (Springfield, IL): March 10, 2015; and $1.32 billion in additional funds due to non-General Fund sweeps under HB 318 of the 99th General Assembly

[48] FY2016 revenue estimate is "Maintenance 2016" revenue estimate from GOMB, *Illinois State Budget: Fiscal Year 2016* (Springfield, IL: February 18, 2015), CH. 2-23

[49] http://ctbaonline.org/sites/default/files/reports/ctbaonline.org/file/ajax/field_report_file/und/form-G35MS30hOlzn9wPWjibXZbyY7x65ksfrRhHkEosdB-U/1421794164/IB_2015.12.22_CTBA%20The%20Pending%20FY2016%20Fiscal%20Cliff_FINAL.pdf

With Sales Taxes, Simplest is Not Best

By Robert Ross

Rob Ross, a Masters Student on Public Policy at the University of Chicago, received his MA in Economics from the University of Illinois. His research focuses on public finance.

Introduction

Taxes have a large impact on the economy, and flawed state tax policy can lead to long-lasting negative consequences for residents. There are many pitfalls in designing a sound tax policy. One of these is the problem of tax pyramiding, which is most common with poorly designed and overly simplistic sales tax regimes. This short article describes the problem of tax pyramiding, and compares two alternative transaction tax structures that attempt to eliminate pyramiding.

What is tax pyramiding, and why is it bad?

The basic mechanism of tax pyramiding is described in the accompanying article "Expanding the Base of Illinois' Sales Tax to Consumer Services Will Both Modernize State Tax Policy and Help Stabilize Revenues." A sales tax is a tax on consumption, not a tax on all transactions. Tax pyramiding occurs when sales taxes are improperly applied to a product at points along its production chain, not just at the final point of sale to the consumer.

This leads to bad outcomes. First, the actual tax on products is largely hidden from the consumer because taxes paid at intermediate stages of production are incorporated into the retail price of the product. Second, the actual tax rate varies dramatically across products and services depending on the complexity of the production chain. The end results of tax pyramiding are economic inefficiency, where producers and consumers change their behavior in response to the tax, and opacity. The table on page 17 demonstrates a fairly straight-forward example of tax pyramiding.

In the table, tax is added at every stage of production. Essentially, a system like this charges taxes on taxes, with the end result being that consumers face significantly higher costs. From the consumer's perspective, she has only paid \$17.89 in sales taxes for a product costing \$178.91. In fact, however, she has paid \$56.80 in transaction taxes for a product worth \$140.00. The consumer believes she is paying a 10% sales tax, when she is in fact paying about 40%. Such a system may be simple, but it is terrible tax policy, and no local, state, or national government generates any meaningful amount of revenue in that fashion.

How do governments avoid tax pyramiding in consumption taxes?

In general, goods and services can be divided into intermediate and final goods. Intermediate

SIMPLE EXAMPLE OF TAX PYRAMIDING WITH A TAX RATE OF 10%				
Production Step	**Cost of Goods**	**Value added at Production Stage(s)**	**Taxes Paid**	**Price Charged to the Next Level of Production**
Raw Materials	**$100.00**	**$5.00**	**$10.50**	**$115.50**
Manufacture	**$115.50**	**$15.00**	**$13.05**	**$143.55**
Assembly	**$143.55**	**$10.00**	**$15.36**	**$168.91**
Retail	**$168.91**	**$10.00**	**$17.89**	**$196.80**
FINAL COST TO CONSUMER, BREAKDOWN				
	Raw Materials	**Value added at Production Stage(s)**	**Taxes Paid**	**Total Cost**
Consumer	**$100.00**	**$40.00**	**$56.80**	**$196.80**
Tax Rate on Final Goods	**40.57%**			

goods are used to make final goods, either directly or by making other intermediate goods. Final goods are used or consumed by the consumer. Whether a good or service is intermediate or final depends on what the purchaser of the good or service does with them. If she consumes them, it is a final good or service. If she uses them to create a product for sale, or re-sells them, it is an intermediate good or service. For example, lumber used by a contractor to construct a house is an intermediate good, while the same lumber sold to a homeowner to build a treehouse is a final good. A lawyer providing legal advice to a company that sells real estate is providing an intermediate service, while a lawyer providing that same advice to a homeowner is providing a final service.

The key to avoiding pyramiding is to tax only final sale to consumer. But this is more complicated than it might seem, as in the examples above. How can the state distinguish between an intermediate and a final good in order to tax the latter but not the former? Here we consider two alternative transaction tax systems: a sales tax structure with exemptions and a VAT structure.

Sales tax with exemptions

The most common sales tax regime in the United States is a flat sales tax applied to all goods transactions, paired with exemptions designed to avoid the most egregious forms of tax pyramiding. States typically identify major business inputs that would be subject to transaction taxes, and exempt those specific goods and services. In Hawaii, goods are often shipped by ferry from the larger islands to the smaller ones. In that situation, applying a sales tax to the price of a ferry ride would certainly produce tax pyramiding, and exempting ferry passage from the sales tax helps reduce tax pyramiding. Other examples of major production inputs are advertising, heavy equipment, and purchases of farm fertilizer. Illinois exempts all these inputs from the sales tax.

States with traditional sales taxes have sale-for-resale or raw materials exemptions that avoid the pyramiding example from the table above, as illustrated below:

While relatively simple to administer and comply with, this sort of tax regime does not eliminate all pyramiding. For example, supplies and equipment purchased by each of the parties involved may not qualify for raw materials or sale-for-resale exemptions. Those taxes are passed on, at least in part, to the next step in the production stage, through higher prices. The broader and more complete the business input exemption, the closer a state's sales tax regime comes to eliminating pyramiding and aligning with good tax policy.

SIMPLE EXAMPLE OF SALES TAX WITH TRADITIONAL EXEMPTIONS, TAX RATE OF 10%				
Production Step	**Cost of Goods**	**Value added at Production Stage(s)**	**Taxes Paid**	**Price Charged to the Next Level of Production**
Raw Materials	**$100.00**	**$5.00**	**$0**	**$105.00**
Manufacture	**$105.00**	**$15.00**	**$0**	**$120.00**
Assembly	**$120.00**	**$10.00**	**$0**	**$130.00**
Retail	**$130.00**	**$10.00**	**$14.00**	**$154.00**
FINAL COST TO CONSUMER, BREAKDOWN				
	Raw Materials	**Value added at Production Stage(s)**	**Taxes Paid**	**Total Cost**
Consumer	**$100.00**	**$40.00**	**$14.00**	**$154.00**
Tax Rate on Final Goods	**10.00%**			

The Value Added Tax (VAT)

A VAT most nearly eliminates tax pyramiding, but can also the most complex and costly to administer. It eliminates most pyramiding because it takes the cost of all business inputs into account when calculating the tax. For this reason, it is overwhelmingly popular among national governments; only 11 countries do not use the VAT or some variation on a VAT. Often, VAT tax schemes incorporate a system of exemptions for certain activities.

A VAT tax applies a tax rate only to the additional value created at each stage in production. The table below illustrates a hypothetical VAT structure as compared to a simple tax structure without exemptions.

The best-designed sales tax systems, with the broadest exemptions for business inputs, very nearly approximate the same results as a VAT. It is not simple, but it is fair, and any efforts to expand Illinois' sales tax to include services should follow this policy.

SIMPLE EXAMPLE OF A VAT WITH A TAX RATE OF 10%				
Production Step	**Cost of Goods**	**Value added at Production Stage(s)**	**Taxes Paid**	**Price Charged to the Next Level of Production**
Raw Materials	**$100.00**	**$5.00**	**$10.50**	**$115.50**
Manufacture	**$155.50**	**$15.00**	**$1.50**	**$132.00**
Assembly	**$132.00**	**$10.00**	**$1.00**	**$143.00**
Retail	**$143.00**	**$10.00**	**$1.00**	**$154.00**
FINAL COST TO CONSUMER, BREAKDOWN				
	Raw Materials	**Value added at Production Stage(s)**	**Taxes Paid**	
Consumer	**$100.00**	**$40.00**	**$14.00**	**-**
Tax Rate on Final Goods	**10.00%**			

Taxing Services: The Practical Side

By Carol Portman

President of the Taxpayers' Federation of Illinois since 2013, Carol Portman has been working in the state and local tax arena for over two decades.

Nothing about taxes is easy, and although there are sound tax policy reasons for taxing consumer services, doing so in Illinois won't be an easy decision to make. Actually implementing the tax, however, is likely to be even more difficult. There are major administrative and logistical issues that must be resolved before Illinois seriously considers taking this step. A few are outlined below.

Bringing new retailers into the system

One of the first practical concerns with taxing services is the number of new tax collectors involved. Many service businesses are already in the sales tax system because they also sell goods. Hair salons, for example, often sell shampoo and other products. Other service providers have never before been required to calculate, collect, and remit sales tax. Educating these new tax collectors about their obligations will take time and effort, and this new government mandate will undoubtedly be a source of frustration and irritation to those businesses and their customers.

New or revised forms, regulations, audit staff

The Department of Revenue will need time to prepare for a major change in our tax structure. Forms have to be developed and revised; regulations have to be drafted, reviewed, proposed, and complete the administrative review process; and DOR staff need to be trained to handle the new taxpayers and issues. The Department will not be caught flat-footed—they have already begun thinking about these issues and more—but it will still take time to implement.

Local sourcing issues

Illinois has had a difficult time determining where a sale of a physical good occurs;[1] the sourcing of a service has even more potential for difficulty. For example, will a computer support service operating out of a Chicago office need to charge tax based on where its customers are based, where their computers are at the time, or will Chicago tax apply? Local governments receive the 1.25% local component of the 6.25% tax from sales occurring within their borders, and many local jurisdictions have imposed higher tax rates, so the tax dollars at stake are not insignificant, both for the taxing jurisdictions and the taxpayers. This issue must be addressed as part of any legislation that expands the tax base to services.

[1] See, e.g., *Hartney Fuel Oil Co v. Hamer*, 2013 IL 115130 (11/21/2013); 86 Ill Admin Code 220.115 and other local sourcing regs finalized effective June 25, 2014; HB 3110 and SB 1548 (99th General Assembly)

Business-to-business transactions

Policy experts of all stripes agree: business inputs should not be subject to consumption taxes, like Illinois' ROT. How exactly to accomplish that goal is less universally agreed upon. Numerous options are available: tax only those types of services that are generally purchased by the ultimate consumer (the most common practice among states taxing services); tax most/all services but establish an exemption process for all business purchasers (similar to what is used by charitable organizations today); tax most/all services but establish an exemption process for certain categories of business inputs (similar to today's sales-for-resale and raw materials exemptions). Each option (and there are surely others) has its strengths and weaknesses, but this issue must also be addressed as part of any service tax effort.

Professional services

Professional services bring all of the irksome issues associated with taxing services together into a single example. Can Illinois tax legal fees for writing a will if the client has homes and assets in several states, and the law firm providing the service has attorneys working on the matter in multiple offices in several different states (and if so, how much of the fees can Illinois tax)? Local sourcing would be nearly impossible for professional services, such as legal, accounting, and medical services. Many professional services transactions are business-to-business in nature. Professionals in particular are mobile and can easily move their businesses elsewhere. All of these factors contribute to the decision by most policy-makers to exempt professional services from sales tax, even in those states where most services are taxed. Illinois should follow that lead.

Other exemptions

Our current sales tax system contains a number of exemptions. There are ones motivated by tax policy, minimizing tax pyramiding and double-taxation, and there are those motivated by social or other policy goals. Exemptions based on the purchaser, like charities and schools, would almost certainly continue to apply to a broader-based tax. Exemptions based on the item purchased, however, will need to be examined one at a time to determine how and whether they should apply. For example, groceries in Illinois are subject to a lower rate of tax. If delivery services are now taxed, would a grocery delivery charge be taxed at the same low rate as the groceries or subject to the full rate? In addition, some level of de minimus exemption for occasional sellers (for example, a neighborhood teenager mowing lawns) will be necessary, as is the case with our current sales tax regime.

Can an "occupation tax" apply to services?

Some have questioned whether there are barriers to a tax on services within Illinois' constitution or existing statutory structure. Illinois' sales tax is not a sales tax at all, but instead a retailers' occupation tax ("ROT"), but that does not appear to be an impediment to taxing services. The ROT statute could be amended so that tax is imposed on the occupation of selling goods *and* services at retail. In *Fiorito v. Jones*,[2] the Illinois Supreme Court overturned a law that expanded Illinois' tax base to certain services, but not on the grounds that a service tax itself is unconstitutional. (The statute unconstitutionally made classifications with no stated or discernible rationale.) The problems associated with taxing services appear to be more philosophical/political and administrative/practical than inherent in our legal structure.

Illinois' existing service occupation tax and service use tax

One unique aspect of Illinois' sales tax structure is the existence of two taxes with "service" in the title: the service occupation tax and the service use tax ("SOT" and "SUT").[3] By their names, it would seem that services are already taxed in Illinois, but that is not the case. The SOT and SUT are imposed on the goods transferred pursuant to the performance of services, not the services themselves. The expansion of our tax base to services will require some revision to these taxes, and it might be the right time to incorporate the SOT and SUT into the existing ROT and Use Tax structure, and perhaps to modernize our "occupation tax" model into a true sales tax structure.

Tip of the iceberg?

TFI supports broad-based, low rate taxes, and taxing services comports with that principle. However, as the partial listing above indicates, there are major administrative and logistical issues to address before Illinois can take steps in that direction. Such a major shift in our tax policy would not be an easy task and could not be accomplished quickly or without serious thought.

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[2] *Fiorito v. Jones,* 39 Ill 2d 531, 236 N.E.2d 698 (1968)

[3] 35 ILCS 115/1 et seq. and 35 ILCS 110/1 et seq., respectively

A Word About Revenue Estimates

When thinking about the fiscal impact of broadening the sales tax to include consumer services, readers should recognize that revenue estimates in the CTBA/TFI report contained in this issue of *Tax Facts* represent a good faith but imprecise effort. We draw on the Commission on Government Forecasting and Accountability's (COGFA's) *Service Taxes 2011 Update* which provided estimates for taxing 92 service industries. These industries provide both consumer and business services, so COGFA attempted to back out business-to-business transactions in order to estimate the potential revenues generated from taxing consumer services.

There are a couple of areas where the estimates may vary significantly from reality. First, the data relies on North American Industry Classification System (NAICS) codes, which may be broader than the service taxed. For example, if Illinois were to tax landscaping services, it would not necessarily tax snow removal services that are included in the same NAICS code and COGFA estimates. Second, COGFA had to project how much of a particular service was business-to-business, and therefore not properly taxed, and we have not tested the accuracy of their models.

The revenue raised from taxing consumer services (or the corresponding tax rate reduction) may very well be smaller than the COGFA-driven estimates. It will be imperative that we obtain more precise estimates before counting on any of the projected revenues. However, the revenue estimate is irrelevant to the core principle: taxation works best when taxes are broad-based and low-rate.

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