SERVICE TAXES

~ 2011 Update ~

Commission on Government Forecasting & Accountability

Illinois General Assembly

April 2011

Commission on Government
Forecasting and Accountability

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EXECUTIVE SUMMARY

This report represents an update to the 2006 and 2009 reports by the Commission on the topic of service taxes. Continued interest in the topic has led the Commission to revisit the estimate it made in these previous reports. Similar to the previous reports, this examination is meant to be an initial analysis and a discussion of the topic that broadly outlines the history and issues related to service taxes. Further investigation and more detailed analysis would be warranted in going forward with any new initiatives concerning taxing services.

The report first looks at the growth of the service sector in both the U.S. and the State of Illinois. The history of service taxes in the U.S. is then investigated. Included in this section is a look at taxes throughout the country and the passage of service taxes over the past twenty years. Service taxes in Illinois are looked at in detail. The report moves on to estimate the potential tax revenue the State could generate from a tax on a wide range of services and concludes with a discussion of topics that might be considered when deciding if services should be taxed and if so, which services to tax. The Commission used information provided by the Federation of Tax Administers and the Bureau of the Census to research this report.

The highlights of the report are:

- In 1975, money spent on services made up approximately 53% of total consumer spending. By 1995, money spent on services had grown to 64% of consumer spending. Service spending has remained around this rate since then. In 2009, consumers spent over $6.7 trillion on services in the U.S.

- Similarly, the Illinois service sector has been growing in recent decades. In 1977, service related industries accounted for approximately 32%, or $37 billion, of the $115 billion Illinois economy. The service sector accounted for $306 billion (48.5%) of the $630 billion Illinois economy in 2009.

- Illinois' economy is more dependent on services than the other Great Lake states primarily due to the increased importance of the 1) Finance and Insurance industry 2) the Professional and Technical Service industry, and 3) the Information industry in Illinois.

- Taxation on services throughout the country has been a piecemeal process over the past twenty years. Newly proposed legislation in numerous states has State legislators considering broader expansions of taxation on services.

- According to the "Survey on Sales Taxation of Services" by the Federation of Tax Administrators, 168 different service categories are taxed in the U.S.

- Hawaii is the state that taxes the most services at 160, followed by Washington (158), New Mexico (158), South Dakota (146), and Delaware (143). Illinois taxes 17 services, while the average state taxes 56.

- Most of the services taxed in Illinois are associated with utilities including: the electricity excise tax; the telecommunications excise tax, and the gas revenue tax. Other services that are taxed include car rentals and hotel rentals.

- An estimate of $8.5 billion in potential tax revenue for the State was calculated using a broad base of services including business-to-business transactions.

- A more narrowly defined estimate of $4.0 billion in potential revenue was estimated after excluding business-to-business transactions.

- These estimates are higher than the 2009 estimate of $3.6 billion and $7.3 billion. This represented compound annual growth of 3.9% and 2.4% which was a slowing of the growth in the service sector when compared to previous reports.

- Volatility, equity, cascading taxes, and opposition to service taxes are all topics that must be taken into consideration when contemplating new service taxes.

I. Growth of the Service Sector

Service related sectors have become more prominent to both the U.S. and the Illinois economy. As manufacturing related sectors have outsourced more of their work to foreign countries, service related sectors have become a larger part of the economy. This is most likely due to the fact that services often have to be performed near the location of the customer; while products can be manufactured other places and shipped great distances to the customer.

Growth in the U.S. Service Sector

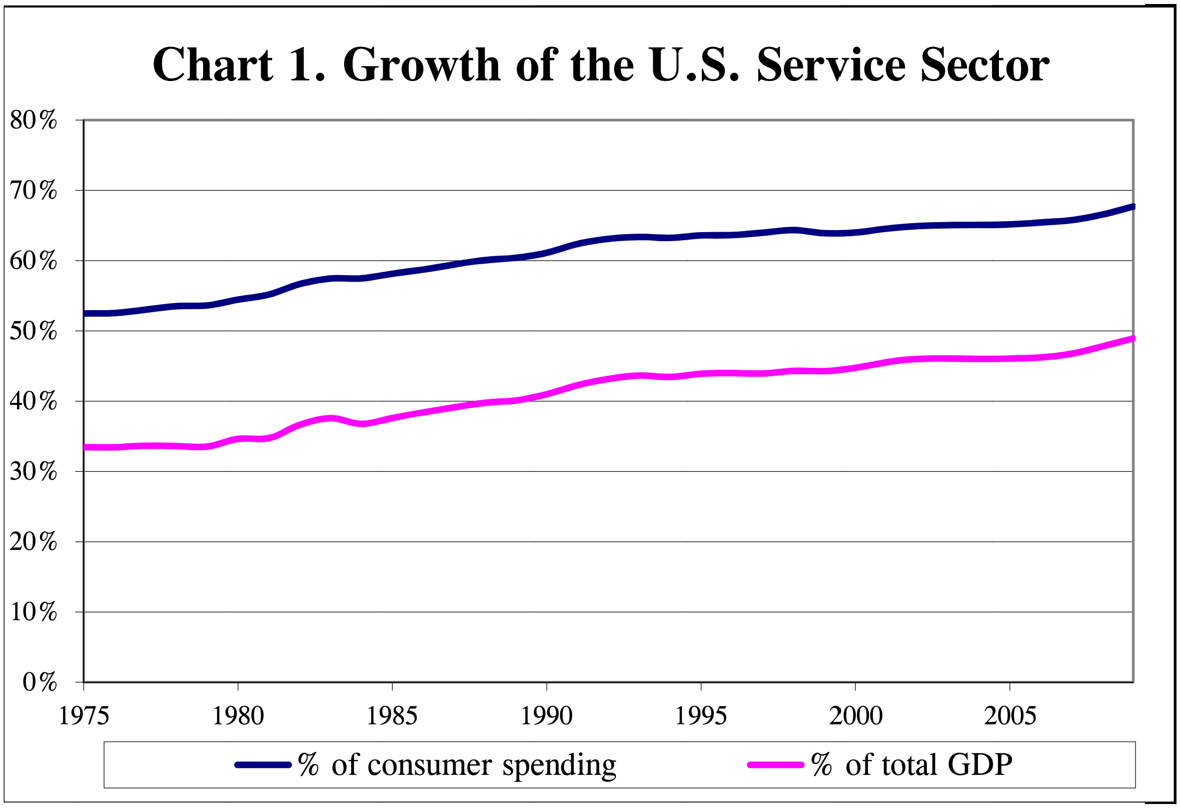
The service sector has become a larger part of the economy in recent years. In 1975, U.S. consumers spent over $543 billion on services. This was in comparison to over $1.0 trillion in total consumer spending. This meant that spending on services made up 52.5% of consumer spending in the U.S. Twenty years later in 1995, money spent on services represented approximately 64% of total consumer spending. Of the $5.0 trillion in consumer spending, over $3.1 trillion went towards services. Service spending has continued to grow since then. In 2009, consumers spent approximately $6.8 trillion on services and over $10 trillion in total consumer spending.

Similarly, total value creation related to services (including exports) has risen over the last thirty years. In 1975, services contributed 34% of total gross domestic product (GDP). GDP is the output of goods and services produced by labor and property located in the United States. In 1995, services had grown to almost 44%. In 2009, the country's GDP was $14.1 trillion with $6.9 trillion or 49% coming from service related industries. The rise in the importance of the service sector to the U.S. economy is illustrated in Table 1 and Chart 1. Due to continued refinement in the methodology in estimating consumer spending and GDP, some data presented may be different than previous versions of this report.

Table 1. Growth of the Service Sector in the U.S.

Year	Consumer Spending on Services ($ Billion)	Total Consumer Spending ($ Billion)	Services as % of Consumer Spending	Net service exports - imports ($ Billion)	Gross Domestic Product ($ Billion)	Total Services as % of GDP
1975	542.5	1,033.8	52.5%	5.4	1,637.7	33.5%
1980	956.0	1,755.8	54.4%	9.7	2,788.1	34.6%
1985	1,580.0	2,717.6	58.1%	5.9	4,217.5	37.6%
1990	2,344.2	3,835.5	61.1%	33.8	5,800.5	41.0%
1995	3,171.7	4,987.3	63.6%	83.5	7,414.7	43.9%
2000	4,371.2	6,830.4	64.0%	80.1	9,951.2	44.7%
2005	5,745.1	8,819.0	65.1%	79.2	12,638.4	46.1%
2009	6,770.6	10,001.3	67.7%	138.4	14,119.0	48.9%

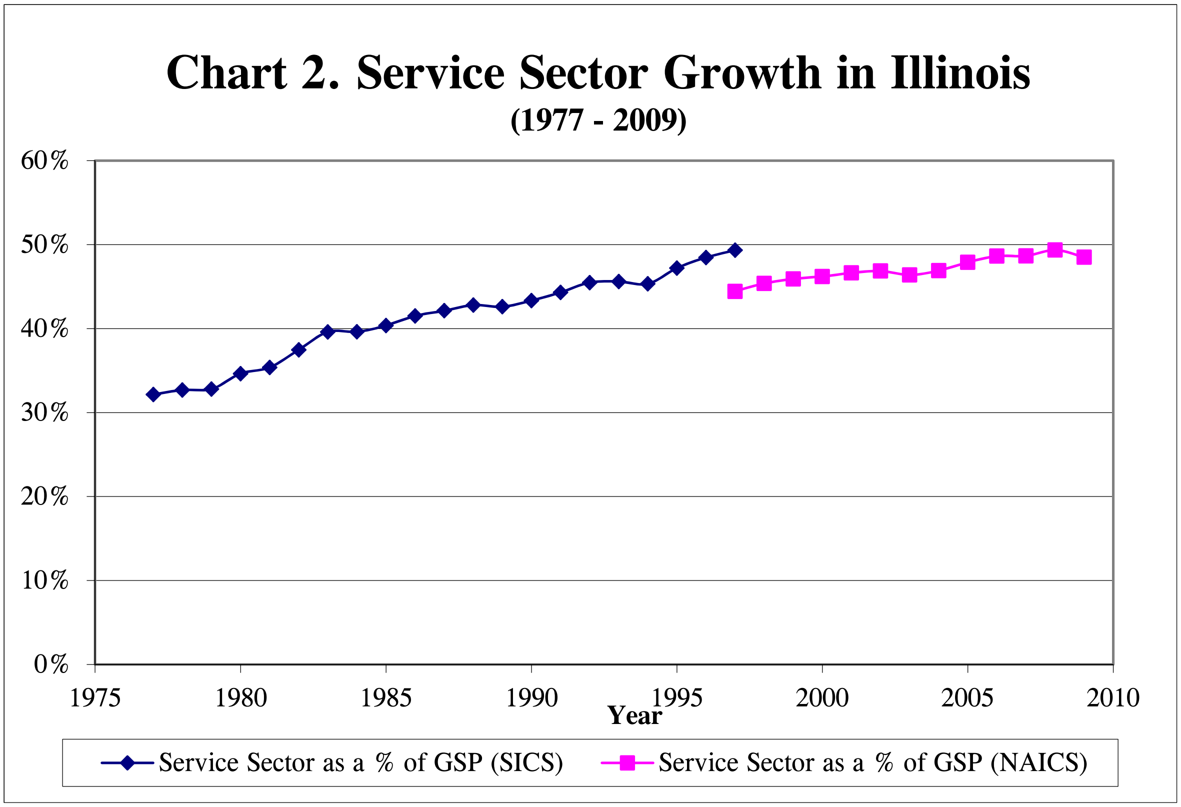
Source: U.S. Department of Commerce, Bureau of Economic Analysis



Growth in the Illinois Service Sector

During this same time period, the Illinois economy had a comparable shift toward the service sector. Based on the service related industries in the Standard International Classification (SIC) and North American Industrial Classification (NAICS) systems, Illinois' service related industries went from approximately 32% to nearly 50% of the state's portion of the country's GDP, which is called Illinois' Gross State Product (GSP). The SIC system was employed by the Department of Commerce through 1997, at which point the department moved to the NAICS system which was felt to be more accurate. Due to this change, the data analyzed must be viewed as segmented and not a perfect match from one system to the other.

In 1977, service related industries in the SIC system accounted for over $37 billion of the State's $115 billion gross state product. Service related industries grew to over $201 billion or 49% of the State's GSP in 1997. In 1997, the NAICS system was established as the new method of determining the State's portion of GDP. Using this method, service industries accounted for $182 billion or 44.4% of Illinois' $409 billion GSP in 1997. Using the NAICS system, service industries have continued to grow as a portion of the economy but not as fast from 1977 - 1997. In 2009, Illinois had a GSP of $630 billion of which approximately $306 billion, or 48.5%, was service related. The growth in service related industries as a portion of Illinois GSP can be seen in Chart 2.



Comparisons with other Great Lake States

Analyzing NAIC data from 2009 (the last year with data from all industries), comparisons from state to state can be made for the Great Lakes region. In 2009, Illinois' service related industries comprised 49.4% of the states GSP. This is the highest of the Great Lake States. Secondary in the region is Ohio at 45.0%, followed by Michigan (43.8%), Wisconsin (41.9%), and Indiana (37.7%). The other Great Lake States service sectors averaged 42.1% of their GDP.

This difference between Illinois and the other Great Lake States is primarily due to the increased importance of 1) the Finance and Insurance industry, 2) the Professional and Technical Service industry, and 3) the Information industry in Illinois. The Finance and Insurance industry and the Professional and Technical Service industry make up almost 3% more in Illinois than in other Great Lakes States, while the Information industry makes up 1% more. One other difference is the decreased percentage the Health Care and Social Assistance industry plays in Illinois' economy. The Health Care and Social Assistance sector accounts for 6.7% of the State's GDP, while this sector averages 8.1% of the other state's economies. The raw data and comparisons between the states are depicted in Tables 2 and 3.

Table 2. Service Industries within the Great Lake States

($ Millions)

Industry Code	Industry	Illinois	Indiana	Michigan	Ohio	Wisconsin
11	Utilities	11,619	5,477	7,693	9,213	4,267
36	Transportation and warehousing, excluding Postal Service	21,688	9,242	9,254	15,566	7,448
45	Information	22,868	5,727	9,793	13,240	7,305
50	Finance and insurance	70,391	19,034	26,635	42,500	23,375
57	Rental and leasing services and lessors of intangible assets	9,336	2,716	4,503	5,658	1,863
58	Professional and technical services	55,282	10,564	30,646	28,251	11,133
62	Management of companies and enterprises	15,590	3,109	8,553	14,421	5,215
63	Administrative and waste services	20,685	6,882	12,820	14,523	5,523
66	Educational services	7,602	2,301	2,944	4,270	2,173
67	Health care and social assistance	42,871	19,810	31,396	40,092	20,857
71	Arts, entertainment, and recreation	5,492	3,235	3,659	3,399	1,747
75	Accommodation and Food Service	16,541	6,298	9,389	11,507	5,838
77	Other services, except government	17,158	6,983	10,319	11,998	6,424
	Total of Service Related Industries	317,123	101,378	167,604	214,638	103,168
	Total Gross State Product	642,456	269,026	382,653	477,245	246,283
	Services as % of GSP	49.4%	37.7%	43.8%	45.0%	41.9%

Source: U.S. Department of Commerce - Bureau of Economic Analysis, 2009, CGFA

Table 3. Service Industries as a Percentage of GSP

Industry Code	Industry	Illinois	Other Great Lake States	Difference
11	Utilities	1.8%	1.9%	-0.1%
36	Transportation and warehousing, excluding Postal Service	3.4%	3.0%	0.3%
45	Information	3.6%	2.6%	1.0%
50	Finance and insurance	11.0%	8.1%	2.8%
57	Rental and leasing services and lessors of intangible assets	1.5%	1.0%	0.4%
58	Professional and technical services	8.6%	5.6%	3.0%
62	Management of companies and enterprises	2.4%	2.1%	0.3%
63	Administrative and waste services	3.2%	2.8%	0.4%
66	Educational services	1.2%	0.9%	0.3%
67	Health care and social assistance	6.7%	8.1%	-1.4%
71	Arts, entertainment, and recreation	0.9%	0.9%	0.0%
75	Accommodation	2.6%	2.4%	0.2%
77	Other services, except government	2.7%	2.6%	0.1%
	Service Related Industries as a % of Gross State Product	49.4%	42.1%	7.3%

Source: U.S. Department of Commerce - Bureau of Economic Analysis, 2009, CGFA

II. Service Taxes in the U.S.

History of Service Taxes

Many states have not taxed services as broadly as tangible property due to when sales taxes were originally enacted. Many states sales taxes were enacted in the 1930s. During this time, services accounted for a smaller portion of overall economic activity. Because of this, most states have tangible personal property as their primary base. This has limited the amount of sales tax revenue, as the country's economy has become more service oriented.

The history of passing taxes related to services has generally been a piecemeal process. As noted in the 1996 version of the service tax report by the Federation of Tax Administrators, in 1990 the service tax laws varied greatly throughout the nation and that with the 1992 update "states were taking a more incremental approach to broadening the sales tax base, by opting to add selected, enumerated services…". The last broad based expansion of sales taxes were in Florida in 1987 and Massachusetts in 1990. Both of these states later repealed these taxes.

One reason that service taxes have been enacted in this piecemeal fashion is due to strong opposition to these laws. Whenever a new service tax is proposed, the business group who is to be taxed will most likely be in opposition. This opposition is often effective due to how organized and politically active some of these groups, such as lawyers, accountants, and doctors, are.

Another reason services have been taxed on a seemingly random basis is the necessity of the service. Some people believe that such things as medical care and legal should not be taxed. They argue that if taxes were applied to these services, the cost would be too high for some people, and they would not seek these services to their own detriment. Law groups in Florida contended that a service tax on their profession would be unconstitutional under Florida law. Service taxes on legal services, however, were later found to be constitutional by the Florida Supreme Court.

During the mid-1990s, state tax revenues increased due to the improvement in the economy. As such, the demand for new revenue sources was not as great and the rate of new taxes on services abated. Since 1996, the amount of service taxes within the country has been relatively steady. From 1996 to 2004, fifty new service taxes were enacted, while forty-six service taxes were repealed. This nets out to only four additional service taxes.

Taxation on services throughout the country has been a piecemeal process over the past twenty years, as reflected in the last broad based taxation on services, which happened in Massachusetts in 1990. Newly proposed legislation in numerous states has State legislators considering broader expansions of taxation on services.

Services Taxed Presently

Services of some sort are taxed in forty-nine states and the District of Columbia. Data collected by the Federation of Tax Administrators on 168 different service categories in the 2007 update of their "Sales Taxation of Services" survey was analyzed. The state that taxes the most services is Hawaii, which taxes 160 different service categories. Washington and New Mexico followed closely at 158 services each. The only other states to tax more than 100 different services are: South Dakota (146), Delaware (143), and West Virginia (105). The state with the least amount of service taxes is Oregon, which does not tax any services. The average number of services taxed is 56, while the median was 55 services taxed. Illinois is considerably below this level at 17 service categories taxed.

The Other Services category is the most heavily taxed category of services. Services included in this category include services related to storage, transportation, and overnight accommodations. Every state except Oregon taxed at least one service in this category. Another leading category was Business Services, which was taxed by all the states except Alaska, Colorado, Montana, and Oregon. Other categories with numerous services taxed were Personal Services (20), Fabrication, Repair and Installation (19), Utilities (16), and Admissions/Amusements (15).

The leading category for Illinois was utilities, which accounted for 12 of the 17 services taxed. These taxes primarily focus on services related to telephone, gas, and electric services. Illinois also taxed one service in each of these categories: Personal Services, Business Services, Computer Services, Fabrication, Repair and Installation, and Other Services. The service taxes for the State of Illinois will be analyzed in greater detail in the next section.

In comparing Illinois with the other Great Lakes states, Illinois is very similar to Indiana and Michigan but very different from Ohio and Wisconsin. Illinois' 17 service taxes are similar to Indiana's 24 and Michigan's 26. In all three of these states, a large amount of the service taxes are related to utilities. Ohio and Wisconsin on the other hand tax 68 and 76 services respectively. Both of these states tax services much more broadly throughout the service categories.

Service tax data for each state and the District of Columbia can be found in Table 4 (on the following page).

Table 4. Comparison of Services Taxed by State

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Amusements	Professional Services	Fabrication, Repair, & Installation	Other Services	Total	State Ranking
Alabama	12	2	6	3	10	0	1	3	37	28
Alaska *	0	0	0	0	0	0	0	1	1	50
Arkansas	16	7	12	1	12	0	11	13	72	15
Arizona	12	2	7	0	9	0	2	23	55	24
California	2	2	7	2	1	0	3	4	21	42
Colorado *	4	0	2	1	2	0	3	2	14	48
Connecticut	10	9	20	6	10	0	10	14	79	9
Delaware *	9	20	33	6	10	9	19	37	143	5
District of Columbia	13	7	15	6	8	0	12	12	73	14
Florida	7	4	9	0	14	0	16	13	63	20
Georgia *	10	4	5	2	8	0	1	6	36	29
Hawaii	16	20	34	8	14	9	18	41	160	1
Iowa	13	15	18	1	14	0	13	20	94	7
Idaho	0	3	5	0	11	0	6	4	29	34
ILLINOIS	**12**	**1**	**1**	**1**	**0**	**0**	**1**	**1**	**17**	**47**
Indiana	7	4	3	2	3	0	1	4	24	41
Kansas	10	11	9	1	13	0	15	15	74	12
Kentucky	11	2	4	0	6	0	4	1	28	36
Louisiana	10	8	5	3	9	0	13	7	55	24
Maine	9	1	6	0	3	0	4	2	25	40
Maryland	5	3	13	1	11	0	4	2	39	27
Massachusetts	9	1	4	0	1	0	2	1	18	43
Michigan	12	2	7	1	1	0	1	2	26	37
Minnesota	15	7	12	2	13	0	6	11	66	19
Mississippi	10	5	8	3	11	0	13	22	72	15
Missouri	8	1	2	2	10	0	0	3	26	37
Montana	12	0	0	0	2	0	0	4	18	43
Nebraska	14	9	14	3	12	0	13	12	77	10
Nevada	0	1	4	0	7	0	2	4	18	43
New Hampshire *	6	1	0	2	0	0	0	2	11	49
New Jersey	12	5	16	1	6	0	15	19	74	12
New Mexico	16	20	32	8	14	9	18	41	158	2
New York	4	4	13	1	6	0	14	15	57	23
North Carolina	10	4	5	0	9	0	1	1	30	33
North Dakota	6	1	4	2	11	0	0	2	26	37
Ohio	8	12	14	5	3	0	12	14	68	17
Oklahoma	9	3	4	1	10	0	0	5	32	31
Oregon	0	0	0	0	0	0	0	0	0	51
Pennsylvania	9	5	16	1	1	0	15	8	55	24
Rhode Island *	10	1	6	3	4	0	3	2	29	34
South Carolina	4	6	7	4	10	0	1	3	35	30
South Dakota	14	19	28	8	13	5	18	41	146	4
Tennessee *	11	10	7	3	12	0	13	11	67	18
Texas	12	10	14	8	12	1	10	16	83	8
Utah	7	8	6	0	11	0	15	11	58	21
Vermont	9	2	5	2	11	0	2	1	32	31
Virginia *	1	3	4	0	1	0	4	5	18	43
Washington	16	20	33	8	13	9	16	43	158	2
West Virginia	6	17	26	4	13	1	13	25	105	6
Wisconsin	11	11	8	3	14	0	14	15	76	11
Wyoming	10	6	6	2	6	0	16	12	58	21
Total	16	20	34	8	15	9	19	47	168	

Source: Federation of Tax Administrators, Sales Taxation of Services, 2007. *States did not respond, 2004 data reported

III. Service Taxes in Illinois

The majority of the service taxes in Illinois come from public utilities. Twelve of the seventeen services identified in the survey by the Federation of Tax Administrators taxed by the State of Illinois were in this category. These twelve services are taxed under three statutes: 1) The Electricity Excise Tax, 2) The Telecommunications (Messages) Excise Tax, and 3) The Natural Gas Revenue Tax.

Other services that are taxed in Illinois include a 6.25% tax on prepaid calling cards, photograph processing, and canned software/modifications to canned software. The Hotel Operators' Occupation Tax Act taxes the gross receipts from hotel or motel rentals. Also, a 5% tax is applied to short term renting of vehicles. Coin-operated amusement and redemption machines are also taxed an annual fee of $30. In addition to these services, materials used in a repair, or installation of a service, are charged at 6.25%.

An explanation of three statutes relating to public utilities services and the other service taxes in Illinois are examined in greater detail below.

The Electricity Excise Tax - 35 ILCS 640

The Electricity Excise Tax is a tax imposed on the privilege of using electricity purchased for use or consumption. Under current law, electric suppliers pass this tax to the residential customer by adding it to the consumer's electric bill. Nonresidential customers can register as "self-assessing purchasers" and pay the tax directly to the Department of Revenue. State laws exempt electricity used by municipalities to operate public transportation systems they own. The rate for residential customers ranges from 0.33 cents per kilowatt-hour to 0.202 cents per kilowatt-hour depending upon total usage per month. The rate for self-assessing (nonresidential) purchasers is 5.1% of the purchase price. Customers of municipal electric systems and rural electric cooperatives pay the LESSER of (a) 0.32 cents per kilowatt-hour OR (b) 5% of purchase price.

Revenue from the State's electricity excise tax has experienced a significant amount of volatility over the last decade while mostly trending up. The revenue collected from this tax is largely affected by weather and business activity. Due to the taxing structure, the volatility is due to consumption fluctuations rather than price fluctuations. Over the last decade, general funds revenue from the electricity excise tax has ranged from $324 million in FY 2001 to $399 million in FY 2008. In FY 2010, the electricity excise tax amounted to $375 million.

The Telecommunications (Messages) Excise Tax – 35 ILCS 630

Six of the twelve utility services listed by the service tax survey fall under this act. The services include two services under Intrastate telephone & telegraph – Industrial Use, two services under Intrastate telephone & telegraph – Residential Use, one service related to Industrial use of cellular phones, and one service related to Residential Use of cellular phones.

The telecommunications (messages) excise tax, the largest revenue producer of the public utility taxes, is imposed on persons who send or receive interstate and/or intrastate telecommunications. This includes telephone, telegraph, channel, private line, teletypewriter, computer exchange, mobile radio, and telephone and paging services. The tax is applied to the transmission of messages or information between or among points by wire, cable, fiber optics, microwave, radio, laser, satellite, and other methods. The tax is collected from the consumer through the telecommunications provider.

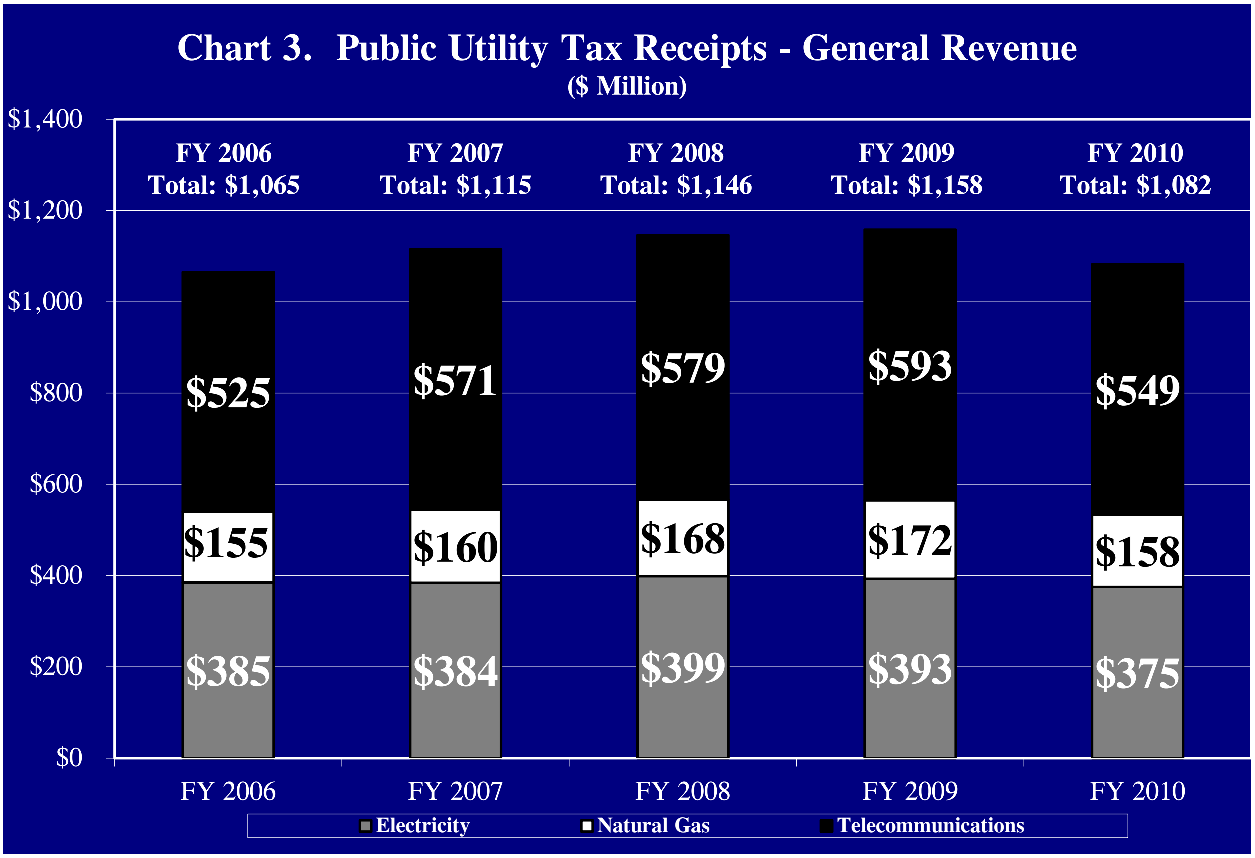
The rate and base of the telecommunications excise tax is simple: 7% of gross charges by businesses for transmitting messages in interstate or intrastate commerce. In FY 2010, $642.6 million was generated from the telecommunications excise tax of which $549.4 million went into the General Revenue Fund and the Common School Fund. The remaining money is transferred into the School Infrastructure Fund.

The Gas Revenue Tax – 35 ILCS 615

The third portion of the public utility tax is the gas revenue tax. This tax is imposed on companies distributing natural gas in Illinois, which can pass it on to customers. All of the natural gas revenue tax is deposited into the General Revenue Fund. The rate and base of the natural gas revenue tax is the LESSER of the following: a) 2.4 cents per therm of gas sold to each customer, OR b) 5% of gross revenue from each customer. All of the revenue collected from this tax is deposited into the General Revenue Fund. In 2008, the State collected $168 million in revenue from this tax.

The gas revenue tax has experienced much volatility over the last decade. This is because, like the electricity tax, the natural gas tax is largely affected by weather, especially the colder months. Because many Illinois homes utilize natural gas to keep their residences warm during cold periods, the amount of natural gas tax receipts collected in a year has a lot to do with how cold it gets, and for how long, in a given year. Regardless of which qualifying rate is used, this tax is dependent on the extent of the usage of the gas, which means, the higher the usage, the more natural gas tax revenue realized for the State. Receipts from the Gas Revenue Tax were $158.3 million in FY 2010.

Revenues for all three public utility taxes can be seen in Chart 3.



Non-Utility Related Service Taxes

Under the Use Tax Act (35 ILCS 105/1), Service Use Tax Act (35 ILCS 110/1), Service Occupation Tax Act (35 ILCS 115/1), and Retailers' Occupation Tax Act (35 ILCS 120/1), in most cases a statewide 6.25% tax is applicable to the sales of tangible personal property. Under three circumstances, this could be considered a service.

These situations are the sale of

1) prepaid telephone cards or other arrangements allowing a buyer to get telephone service,
2) photograph processing, and
3) canned software or modifications to canned software.

Currently, no service tax revenue information is available for these services. The revenues collected by the taxes are distributed according to the sales tax distribution method.

The Hotel Operator's Occupation Tax Act – 35 ILCS 145

The Hotel Operator's Occupation Tax Act applies a tax on 5% of 94% of gross receipts from short-term hotel and motel rentals (Section A.). This rental must not be more than

30 consecutive days; otherwise the tax is not applicable. In addition to this tax, a 1% of 94% of gross receipts tax is imposed on permanent residents who stay in excess of 30 consecutive days (Section B).

The Metropolitan Pier and Exposition Authority (MPEA) impose a tax on hotels and motels operating within the City of Chicago. The MPEA imposes a tax of 2.5% of gross receipts on these hotels, which is collected by the Illinois Department of Revenue and distributed with the other receipts from the Hotel Operator's Occupation Tax.

In FY 2008, the Hotel Operator's Occupation Tax had receipts of $219.2 million. Of this $219.2 million, $109.6 million went to the Build Illinois Fund, $43.6 million was transferred to MPEA, $33 million went to the Illinois Sports Facilities Fund, $17.5 was distributed to the Local Tourism Fund, and $9.8 went to the International Tourism Fund. The remaining $5.7 million remained in the General Revenue Fund.

The Automobile Renting Occupation and Use Tax Act – 35 ILCS 155/3 and 4

The Automobile Renting Use Tax applies to the lessee of any automobile; van with capacity of 7-16 passengers' or recreational vehicle, for the privilege of using it on Illinois highways. The tax is 5% of the automobile rental charge. This tax is only applicable for rentals of less than one year in duration. All proceeds from this tax go to the General Revenue Fund. In FY 2008, the State collected $32.7 million from this tax. In addition to this State tax, several other local government taxes are imposed in different areas of the State.

Coin-Operated Amusement Device Tax – 35 ILCS 510/1 to 510/16

The tax is imposed on the privilege of operating amusement devices that require insertion of coins, tokens, chips or similar objects. Jukeboxes, pinball machines, kiddie rides, and coin-operated video games are among the many coin-operated amusement devices that are required to display state decals under the Coin-Operated Amusement Device and Redemption Machine Tax Act. Exempt devices include crane machines and vending machines, e.g., candy, soda, cigarette, newspaper. The tax is also imposed on the privilege of operating redemption machines — single-player or multi-player amusement devices involving a game whose purpose is to propel an object into, upon, or against a target.

This tax is somewhat different than the other in that the tax rate on coin-operated amusement devices is on a per device basis instead of being based upon total sales. The annual fee per device is $30. This fee brings in approximately $2.0 to $2.5 million per year. As the actual machines are taxed and not the service of providing amusement, sales from these types of activities will be included in the potential tax revenue estimates calculated later in this report.

IV. Potential Revenues from New Service Taxes

To estimate potential revenue that could be generated from the taxation of services, the Commission used information on the services identified by the service tax survey conducted by the Federation of Tax Administrators in conjunction with data from the 2007 economic census. Receipt data for the related Illinois industries were identified through NAICS codes that conformed to the taxed services in the survey from 2007. These receipts were then grown by individual industry growth rates from the U.S. Census Bureau's Annual Services or state level GDP data to get a 2008 sales estimate. These results were then grown based on a 5-year growth average to calculate 2011 sales levels.

These totals were then adjusted by subtracting the estimated proportion of those receipts that were deemed to already be taxed. This adjustment was done to account for sales associated with parts and materials related to services, which are already taxed under the Service Use Tax Act, and for food that was prepared for immediate consumption, which is taxed under the Retailer's Occupation Tax Act.

Two estimates were calculated using this methodology at a tax rate of 5.0% to the State and 1.25% to local governments, which coincides with the general sales tax. The first estimate was generated using all the services identified by the survey plus a few services not identified by the survey but that could be taxed. This estimate was meant to encompass all potential revenue that could be generated regardless of previous tax policy.

The second estimate defined potentially taxable services more narrowly. The second method took into account the State's tax policy legacy of not taxing business-to-business transactions. Information from the Bureau of Economic Analysis' national input-output models was used to calculate the percentage of individual industry's outputs that went to final users. Final use goods and services are those goods and services used by final consumer and not used by industries as inputs for intermediate production. These percentages were applied to the first estimate to arrive at a more narrowly focused estimate. Services already taxed by the State of Illinois, such as utilities, hotel rentals, and car rentals, were excluded from both estimates. Both estimates assume an increase in transaction price that is completely taken on by the buyer and no decrease in total sales.

Broad Based Estimate

Using all potential NAICS codes related to services minus revenue related to parts and materials and those services already taxed, the first estimate showed potential income to the State of $8.45 billion. Potential income to local governments equaled $2.11 billion. The majority of this potential revenue comes from four sectors. The largest sector is the Professional Services sector that accounts for $2.9 billion or 34% of the total potential tax revenue. The second largest sector contributing to the estimate is the Business Services sector, which represents $1.4 billion towards the estimate. These sectors were followed by the Finance, Real Estate, and Insurance sector and the Construction sector at $1.0 billion and $886 million. The remaining sectors contribute 26.2%, or $2.2 billion, of the

Table 5. Broad Based Estimate				
Sector	**Establishments**	**Est. 2011 Untaxed Revenue** ($1,000)	**Potential Tax Revenue** ($1,000s)	**Sector % of Total**
Agricultural Services	5,379	3,575,975	178,799	2.1%
Industrial and Mining Services	213	369,071	18,454	0.2%
Construction	19,650	17,715,295	885,765	10.5%
Transportation Services	1,438	5,553,330	277,667	3.3%
Storage	934	2,328,645	116,432	1.4%
Utility Service	890	4,595,085	229,754	2.7%
Finance, Insurance and Real Estate	10,405	20,775,222	1,038,761	12.3%
Personal Services	9,083	3,830,523	191,526	2.3%
Business Services	16,431	28,838,886	1,441,944	17.1%
Computer Services	3,489	8,632,276	431,614	5.1%
Automotive Services	934	803,290	40,164	0.5%
Admissions & Amusements	2,780	7,770,115	388,506	4.6%
Professional Services	32,498	57,469,019	2,873,451	34.0%
Leases and Rentals	1,793	3,263,769	163,188	1.9%
Fabrication, Installation and Repair Services	9,892	3,504,431	175,222	2.1%
Total	**115,809**	**169,024,931**	**8,451,247**	**100%**
Sources: Federation of Tax Administrators and Bureau of the Census				

total estimated potential tax revenue from taxing services. Totals for all the estimated sectors can be found in Table 5.

Refined Estimate

The same approach as the first estimate was used for the second estimate except the final totals were reduced by the amount for each industry that is associated with business-to-business transactions. This estimate is based on the receipts for business transactions to end-users. Table 6 shows the average proportion of receipts that were accounted for by final use transactions, the estimated total sales receipts, and the total potential income from taxing these transactions.

This estimate totaled $4.0 billion of potential revenue to the State. Local governments could expect to see an increase of $1.0 billion. The professional services sector continues to contribute the most to the estimate at over $1.4 billion or 35.3% of the total. Unlike the first estimate, the Business services sector contributes much less towards this estimate. In the first estimate this sector accounted for 17.1% of the total taxes estimated. In this estimate they only account for 6.1% of the potential revenue. The construction sector, on the other hand, is much more important in this estimate. The construction sector represents $736 million, or 18.4%, of the total estimated revenue. Admissions and amusements are a bigger factor in this estimate at $300 million or 7.5% of the total.

Detailed information on both estimates, including the percentage of final use sales for each industry and the number of states taxing each service, can be found in Appendix A.

Comparisons between the 2009 and 2011 estimates

This report estimates that service related sales taxes could amount to between $4.0 billion and $8.5 billion per year. The estimate the Commission presented in the 2006 report was between $3.6 billion and $7.3 billion. This is a 16.5% increase of the broad based estimate and a 10.0% increase in the refined estimate. This equates to a compound annual growth rate of 3.9% and 2.4% respectively. This represents a slowing of the growth rate in this potential tax as the Illinois service sectors grew 6.5% in 2006 and 4.9% in 2007.

This rate will most likely continue to decline in the short term as actual data used to calculate this estimate ended in 2008 and a 5-year average was used thereafter to estimate 2011 sales receipts. Economically, 2009 was a bad year and most likely will show a continued decline in the growth of the service sector when actual data is available. Data for 2010 and 2011 may show a return to higher growth rates but that remains unclear.

Table 6. Refined Estimate (excludes business-to-business transactions)

Sector	Average Final Use %	Final User Service Receipts ($1,000)	Refined Tax Revenue ($1,000s)	Sector % of Total
Agricultural Services	23.1%	826,050	41,303	1.0%
Industrial and Mining Services	9.5%	8,782	439	0.0%
Construction	83.1%	14,721,410	736,070	18.4%
Transportation Services	41.2%	2,287,972	114,399	2.9%
Storage	48.1%	1,018,614	50,931	1.3%
Utility Service	18.9%	868,471	43,424	1.1%
Finance, Insurance and Real Estate	53.2%	11,052,418	552,621	13.8%
Personal Services	53.6%	1,821,476	91,074	2.3%
Business Services	21.0%	5,513,353	275,668	6.9%
Computer Services	55.9%	2,931,574	146,579	3.7%
Automotive Services	56.1%	505,859	25,293	0.6%
Admissions & Amusements	77.3%	6,006,299	300,315	7.5%
Professional Services	53.3%	28,274,674	1,413,734	35.3%
Leases and Rentals	55.6%	1,726,768	86,338	2.2%
Fabrication, Installation and Repair Services	71.0%	2,488,146	124,407	3.1%
Total		**80,051,867**	**4,002,593**	**100%**

Sources: Federation of Tax Administrators, Bureau of the Census, and Bureau of Economic Analysis

V. Considerations When Taxing Services

Volatility

Groups have argued that a well-designed sales tax system provides for a relatively stable revenue source even during times of economic recession as consumer spending stays relatively unchanged. To be defined as a well-designed system, they believe that a sales tax must be broadly defined to tax the spectrum of purchases that consumers buy. As mentioned previously, the service sector of the State's economy has grown, while the taxes on services has been insignificant. Those favoring a movement toward the taxation of services believe that the Illinois sales tax system would have a broader base and better represent the actual spending of consumers within the State. By doing this, they think sales tax revenue would be less volatile and more stable revenue source for the State. The opposing view to this argument is that any additional tax, whether broadening the base or not, is still onerous on the taxpayer, especially during periods of recession.

Equity

Another potential advantage of taxing services that is put forth by advocates is that with the passage of such taxes, the State's tax system would be more equitable. Due to the fact that the sales tax system was constructed when tangible property transactions were more prominent, these kinds of transactions were taxed the most. This led to a heavier tax burden on people who choose to purchase more tangible property than those who choose to purchase services. As noted by the Center for Tax and Budget Accountability:

> **"The approach Illinois has taken -- uniformly exempting sales of services, while taxing most sale of tangible property -- discriminates against taxpayers who prefer to consume commodities and in favor of those who consume services."**
>
> **--- Center for Tax and Budget Accountability**

While the taxation of services would make the tax system more equitable on a tangible property consumer versus service consumer basis, some people have argued that the taxation of certain services would be inequitable. Groups have argued that services such as medical care, legal services, and financial services, should not be taxed because the associated additional could cause lower income consumers to avoid these services, due to the increased cost, at their own detriment. Any decision not to tax these kinds of services would lower the second estimate up to $630 million depending on which services would be exempt.

Cascading Taxes

As mentioned previously, business-to-business transactions traditionally have not been taxed, though it still happens in some cases. This is done to avoid cascading taxes, also known as pyramiding. Cascading occurs when a tax that is paid by successive sellers of products and services as those products and services are sold and the subsequent seller is subject to the tax on its sales as it travels through the value chain. As shown in the two estimates, this can make a large difference in the amount of potential revenue available from taxing services. In the Commission's case, the estimate including business-to-business transactions was over two times larger than the estimate excluding these transactions. This also comes into play when considering the taxation of home rentals. Home renters in effect are already paying property taxes as these taxes are taken into account when the rental price is determined.

Opposition to the Taxation of Services

As mentioned previously, the taxation of services is often strongly opposed by business groups that would be taxed under any new legislation. These groups have proven to be effective at blocking the taxation of services due to their high degree of organization and political connections. This is one reason that the broad taxation of services has not been approved over the last fifteen years and a more piecemeal taxation of services has occurred throughout the country. In Illinois up to 100,000 business establishments could be affected by the taxation of a wide range of services.

VI. Conclusion

In conclusion, service taxes have repeatedly been brought up as a potential stream of revenue for the State. The service sector has become a greater portion of the economy in both the nation and Illinois. Services are taxed differently throughout the country but not very broadly in Illinois. Potential revenue from the taxation of services was estimated between $4.0 billion and $8.5 billion. The growth in the service tax estimates from the 2009 report is mainly due natural growth in the service economy though this growth has been dampened due to the recent recession. Volatility, equity, cascading taxes, and opposition to the taxation of services are all topics that must be considered when considering imposing such new taxation.

Appendix A. Service Tax Estimate

NAICS Code	Services	Est. 2011 Untaxed Revenue ($1,000s)	Broad Based Tax Revenue ($1,000s)	Final Use %	Refined Base Tax Revenue ($1,000s)	States Taxing Service
Agricultural Services						
54194	Veterinary services (both large and small animal)	982,754	49,138	23.1%	11,351	5
81291	Pet care (excluding veterinary) services	123,981	6,199	23.1%	1,432	18
56173	Landscaping services (including lawn care)	2,469,240	123,462	23.1%	28,520	21
Industrial and Mining Services						
54136/213112	Oil Field Service / Seismograph & Geophysical Services	46,467	2,323	18.9%	439	10
323122	Typesetting service; platemaking for the print trade	322,604	16,130	0.0%	0	21
Construction						
237236	Gross Income of Construction Contractors	N/A	N/A	N/A	N/A	12
238	Carpentry, painting, plumbing and similar trades.	17,715,295	885,765	83.1%	736,070	13
Transportation Services						
485	Income from intrastate transportation of persons	1,662,322	83,116	41.2%	34,244	11
492	Intrastate courier service	3,891,008	194,550	41.2%	80,155	7
Storage						
49311	General warehousing and storage	1,161,462	58,073	41.2%	23,926	13
49312	Refrigerated warehousing and storage	223,770	11,189	41.2%	4,610	16
49313/49319	Farm product and other warehousing and storage	247,221	12,361	41.2%	5,093	10
53113	Mini -storage	238,207	11,910	53.2%	6,336	14
71393	Marina Service (docking, storage, cleaning, repair)	84,840	4,242	77.3%	3,279	17

NAICS Code	Services	Est. 2011 Untaxed Revenue ($1,000s)	Broad Based Tax Revenue ($1,000s)	Final Use %	Refined Base Tax Revenue ($1,000s)	States Taxing Service
48833	Marine towing service (incl. tugboats)	143,140	7,157	41.2%	2,949	8
488991	Packing and crating	230,005	11,500	41.2%	4,738	10
Utility Service						
22132/562	Sewer and refuse, industrial and residential use	4,595,085	229,754	18.9%	43,424	15
Finance, Insurance and Real Estate						
52392/3	Investment counseling	13,176,352	658,818	53.2%	350,491	6
52231	Loan broker fees	762,993	38,150	53.2%	20,296	3
5312	Property sales agents (real estate or personal)	3,554,170	177,709	53.2%	94,541	5
5313	Real estate management fees (rental agents)	3,281,707	164,085	53.2%	87,293	5
Personal Services						
812111/2	Barber shops and beauty parlors	894,184	44,709	71.0%	31,744	7
56174	Carpet and upholstery cleaning	195,792	9,790	18.9%	1,850	19
81299	Other Personal Services (Dating, massage, and bail bond services)	146,229	7,311	71.0%	5,191	8
81221	Funeral homes and funeral services	338,045	16,902	71.0%	12,001	13
5619	Gift and package wrapping service	N/A	N/A	N/A	N/A	21
81219	Health clubs, tanning parlors, diet salons	293,711	14,686	71.0%	10,427	22
81231	Laundry and dry cleaning services, coin-op	139,174	6,959	71.0%	4,941	6
81232	Laundry and dry cleaning services, non-coin op	295,198	14,760	71.0%	10,480	22
56151	Travel agent services	1,398,209	69,910	18.9%	13,213	4
541921	Photographic studios, portrait	129,982	6,499	18.9%	1,228	N/A
Business Services						
	Sales of advertising time or space:					
54185	Billboards	307,818	15,391	18.9%	2,909	4
54184	Radio & television advertising	629,035	31,452	18.9%	5,944	2
54181	Advertising agencies	2,794,999	139,750	18.9%	26,413	11

NAICS Code	Services	Est. 2011 Untaxed Revenue ($1,000s)	Broad Based Tax Revenue ($1,000s)	Final Use %	Refined Base Tax Revenue ($1,000s)	States Taxing Service
561613	Armored car services	93,932	4,697	18.9%	888	16
56144	Check & debt collection	802,544	40,127	18.9%	7,584	8
54143	Commercial art and graphic design.	574,404	28,720	18.9%	5,428	23
812331	Commercial linen supply	120,544	6,027	71.0%	4,279	33
56145	Credit bureaus	1,029,636	51,482	18.9%	9,730	13
56131	Employment placement agencies and executive search services	1,928,032	96,402	18.9%	18,220	11
54141	Interior design and decorating	262,808	13,140	18.9%	2,484	10
56172	Maintenance and janitorial services	2,765,870	138,294	18.9%	26,137	19
541613	Marketing consulting services	2,982,291	149,115	18.9%	28,183	6
56171	Exterminating and pest control services	321,343	16,067	18.9%	3,037	21
561439	Photocopying services	162,302	8,115	18.9%	1,534	43
32311	Printing	3,866,493	193,325	18.9%	36,538	45
561611	Investigation services	192,522	9,626	18.9%	1,819	16
54182	Public relations agencies	540,394	27,020	18.9%	5,107	7
56141/561492	Secretarial and court reporting services	273,395	13,670	18.9%	2,584	8
561612	Security guards and patrol services	1,013,336	50,667	18.9%	9,576	18
54189	Sign construction and installation	N/A	N/A	N/A	N/A	31
561422	Telemarketing bureaus and other contact centers	698,065	34,903	18.9%	6,597	6
561421	Telephone answering service	79,259	3,963	18.9%	749	20
56132	Temporary help services	5,940,576	297,029	18.9%	56,138	10
54138	Testing laboratories (excluding medical)	1,103,353	55,168	18.9%	10,427	8
326212	Tire Retreading	59,145	2,957	18.9%	559	28
56179	Other services to buildings & dwellings	296,790	14,839	18.9%	2,805	19
Computer Services						
541511	Custom computer programming services	5,258,736	262,937	18.9%	49,695	29
518	Data processing, hosting and related services	2,751,325	137,566	54.7%	75,249	N/A
518111	Internet Service Providers	Included in 518	Included in 518	18.9%	Included in 518	12
519190	Information services	384,820	19,241	54.7%	10,525	13
518210	Data processing services	Included in 518	Included in 518	18.9%	Included in 518	9

NAICS Code	Services	Est. 2011 Untaxed Revenue ($1,000s)	Broad Based Tax Revenue ($1,000s)	Final Use %	Refined Base Tax Revenue ($1,000s)	States Taxing Service
	Books - Downloaded	67,360	3,368	93.6%	3,152	15
	Music - Downloaded	94,255	4,713	93.6%	4,411	15
	Movies/Digital Video - Downloaded	75,780	3,789	93.6%	3,547	16
Automotive Services						
81293	Parking lots & garages	586,926	29,346	71.0%	20,836	21
48841	Motor vehicle towing	216,364	10,818	41.2%	4,457	19
Admissions & Amusements						
71311	Amusement park admission & rides	135,213	6,761	77.3%	5,226	36
71399	All other amusement and recreation industries	56,542	2,827	77.3%	2,185	27
71395	Bowling alleys	170,706	8,535	77.3%	6,598	27
7113	Circuses and fairs -- admission and games	697,475	34,874	77.3%	26,957	34
71312	Coin operated video games / Pinball machines	77,101	3,855	77.3%	2,980	19
71391	Membership fees in golf clubs.	636,936	31,847	77.3%	24,618	23
7112	Admission to spectator sports (excluding horse tracks)	1,303,949	65,197	77.3%	50,398	22
51213	Motion picture and video exhibition	372,293	18,615	77.3%	14,389	N/A
5175	Cable & other program distribution	3,845,737	192,287	77.3%	148,638	25
7111	Admission to cultural events	474,162	23,708	77.3%	18,326	31
Professional Services						
5412	Accounting and bookkeeping	8,371,926	418,596	18.9%	79,115	5
54131	Architects	2,050,132	102,507	18.9%	19,374	5
5411	Attorneys	16,553,828	827,691	18.9%	156,434	5
6212	Dentists	3,789,904	189,495	96.4%	182,673	4
54133	Engineers	7,845,991	392,300	18.9%	74,145	5
54137	Land surveying	178,717	8,936	18.9%	1,689	7
6215	Medical test laboratories	1,356,711	67,836	96.4%	65,393	4
62311	Nursing care facilities	2,987,019	149,351	96.4%	143,974	4
6211	Physicians	14,334,791	716,740	96.4%	690,937	4

NAICS Code	Services	Est. 2011 Untaxed Revenue ($1,000s)	Broad Based Tax Revenue ($1,000s)	Final Use %	Refined Base Tax Revenue ($1,000s)	States Taxing Service
Leases and Rentals						
5322	Personal property	1,254,307	62,715	53.2%	33,365	45
532112	Long term automobile lease	1,629,265	81,463	53.2%	43,338	40
5323	General rental centers	121,543	6,077	53.2%	3,233	N/A
48121	Chartered flights (with pilot)	199,147	9,957	41.2%	4,102	9
7212	Trailer parks - overnight	59,505	2,975	77.3%	2,300	29
Fabrication, Installation and Repair Services						
811	Labor charges - repairs other tangible property	3,504,431	175,222	71.0%	124,407	24
Total		**169,024,931**	**8,451,247**		**4,002,593**	

N/A = Data Not Available

Source: Sales Taxation of Services - 2007 Update, Federation of Tax Administrators; Economic Census and Annual Services Report, Bureau of the Census

BACKGROUND

The Commission on Government Forecasting and Accountability (CGFA), a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;
2) Analysis of the fiscal impact of revenue bills;
3) Preparation of State debt impact notes on legislation which would appropriate bond funds or increase bond authorization;
4) Periodic assessment of capital facility plans;
5) Annual estimates of public pension funding requirements and preparation of pension impact notes;
6) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services;
7) Administration of the State Facility Closure Act.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes several reports each year. In addition to a "Monthly Briefing", the Commission publishes the "Revenue Estimate and Economic Outlook" which describes and projects economic conditions and their impact on State revenues. The "Legislative Capital Plan Analysis" examines the State's capital appropriations plan and debt position. "The Financial Conditions of the Illinois Public Retirement Systems" provides an overview of the funding condition of the State's retirement systems. Also published are an Annual Fiscal Year "Budget Summary"; "Report on the Liabilities of the State Employees' Group Insurance Program"; and "Report of the Cost and Savings of the State Employees' Early Retirement Incentive Program". The Commission also publishes each year special topic reports that have or could have an impact on the economic well-being of Illinois. All reports are available on the Commission's website.

These reports are available from:

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http://www.ilga.gov/commission/cgfa2006/home.aspx