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2009 Update – July 2009*

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## EXECUTIVE SUMMARY

This report represents an update to the 2006 report by the Commission on the topic of service taxes. Recent interest in the topic has led the Commission to revisit the estimate it made in the 2006 report along with updating the summary of what services other States tax. Similar to the previous report, 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 tax 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 Administrators 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 46% of total consumer spending. By 1995, money spent on services had grown to 58% of consumer spending. Service spending has remained around this rate since then. In 2008, consumers spent over \$6.0 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 \$271 billion (43.9%) of the \$617 billion Illinois economy in 2007.
- 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, as reflected in the last broad based taxation on services, which happened in Massachusetts in 1990.
- 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 \$7.3 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 \$3.6 billion in potential revenue was estimated after excluding business-to-business transactions.
- These estimates are higher than the 2006 estimate of \$2.2 billion and \$5.7 billion. The differences in the estimates beyond the natural growth in the service sector can be accounted for by changes in the methodology of how the 2002 base data was estimated forward and changes in the application of final use percentages for the refined estimate.
- 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.

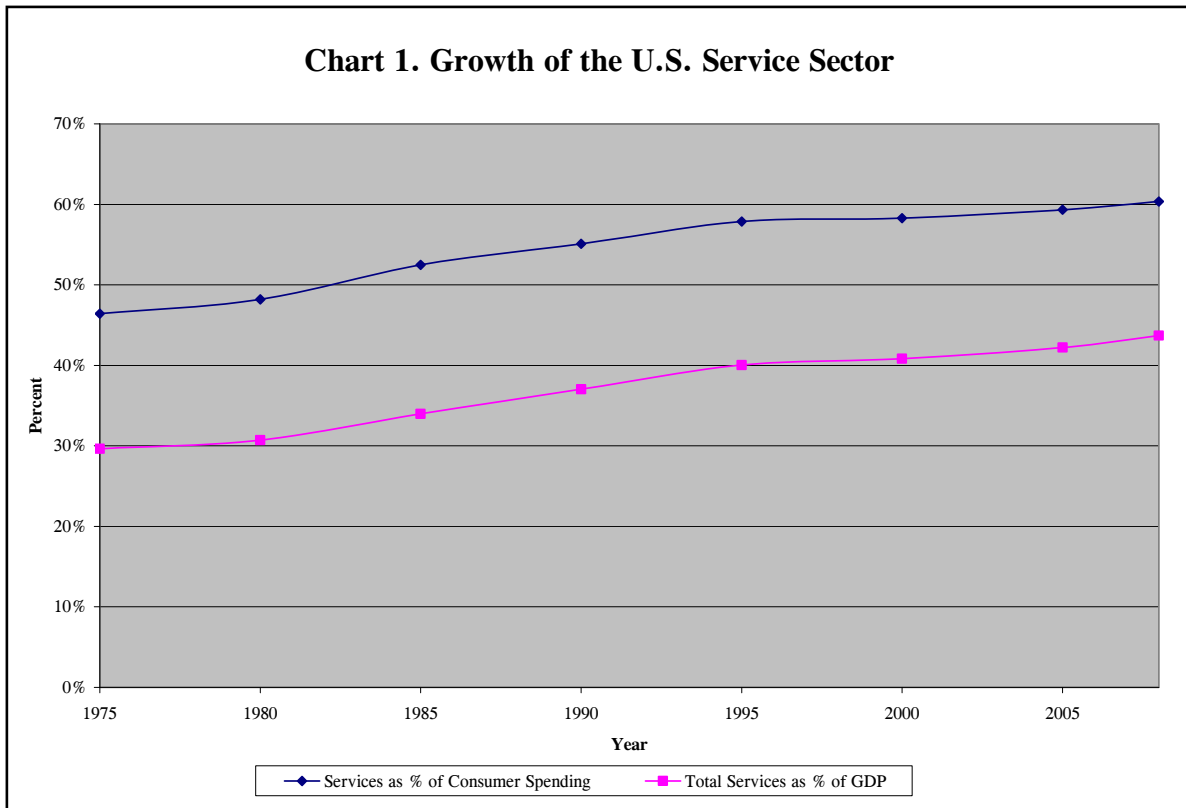
### Growth in the U.S. Service Sector

The service sector has become a larger part of the economy in recent years. In 1975, U.S. consumers spent over \$480 billion on services. This was in comparison to over \$1.0 trillion in total consumer spending. This meant that spending on services made up 46.4% of all consumer spending in the U.S. Twenty years later in 1995, money spent on services represented approximately 58% of total consumer spending. Of the \$5.0 trillion in consumer spending, \$2.9 trillion went towards services. Service spending has remained around this percentage since then. In 2008, consumers spent approximately \$6.1 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 29.6% of total gross domestic product (GDP). In 1995, services had grown to over 40%. In 2008, the country's GDP was \$14.3 trillion with \$6.2 trillion or 43.7% 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.

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	480.2	1,034.4	46.4%	5.4	1,638.3	29.6%
1980	846.9	1,757.1	48.2%	9.7	2,789.5	30.7%
1985	1,428.1	2,720.3	52.5%	5.9	4,220.3	34.0%
1990	2,115.9	3,839.9	55.1%	33.4	5,803.1	37.0%
1995	2,879.1	4,975.8	57.9%	82.8	7,397.7	40.0%
2000	3,928.8	6,739.4	58.3%	79.6	9,817.0	40.8%
2005	5,159.2	8,694.1	59.3%	83.3	12,421.9	42.2%
2008	6,069.6	10,057.9	60.3%	162.9	14,264.6	43.7%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2008



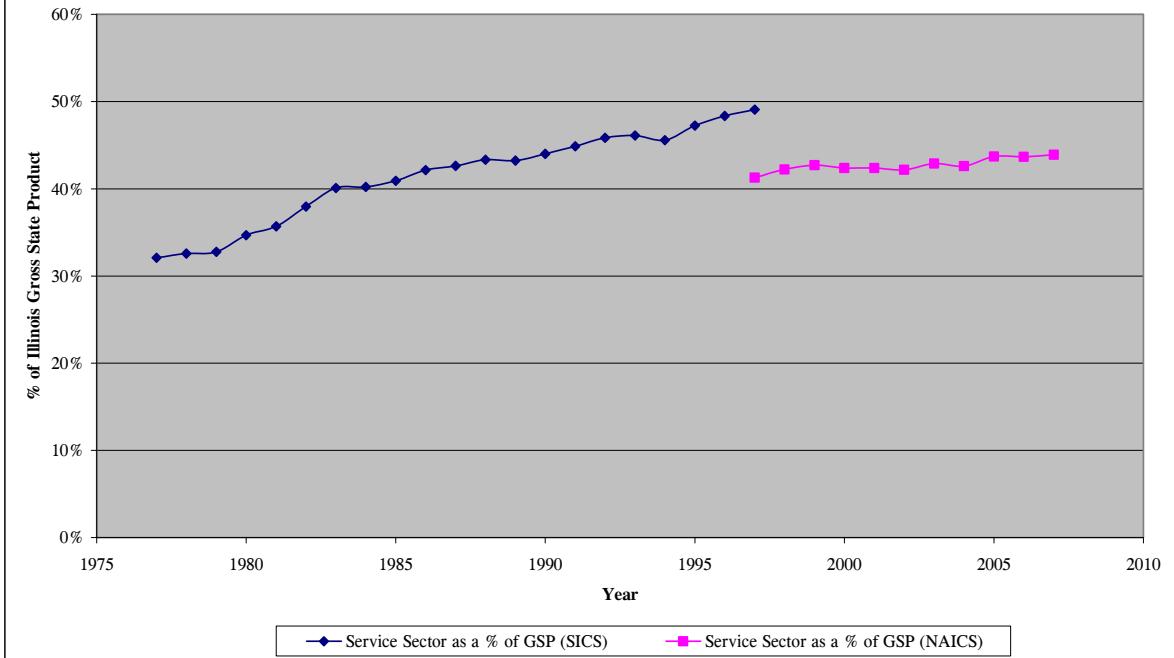
### *Growth in the Illinois Service Sector*

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. 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 \$401 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 \$167 billion or 41.3% of Illinois' \$404 billion GDP in 1997. Using the NAICS system, service industries have been consistently around 43% of the State's GSP. In 2007, Illinois had a GDP of \$617 billion of which approximately \$271 billion, or 43.9%, was service related. The growth in service related industries as a portion of Illinois GDP can be seen in Chart 2.



**Chart 2. Service Sector Growth in Illinois  
(1977 - 2007)**



**Comparisons with other Great Lake States**

Analyzing NAIC data from 2007 (the last year with data from all industries), comparisons from state to state can be made for the Great Lakes region. In 2007, Illinois’ service related industries comprised 43.9% of the states GDP. This is the highest of the Great Lake States. Secondary in the region is Ohio at 39.1%, followed by Michigan (39.1%), Wisconsin (36.1%), and Indiana (33.6%). The other Great Lake States service sectors averaged 37.0% of their GDP. This is an increase of 2.9% since 2002 when the other Great Lakes had service sectors that made up 34.1% of their GDP. Illinois’ service sectors also became a larger portion of the economy but only up 1.7% from the previous reports 42.2%.

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. 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 6.6% 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
36	Transportation and warehousing, excluding Postal Service	22,032	9,638	10,265	15,972	7,700
45	Information	21,690	5,359	10,394	11,937	6,893
50	Finance and insurance	59,409	15,081	23,713	36,548	17,366
57	Rental and leasing services and lessors of intangible assets	6,173	2,058	3,053	3,749	1,290
58	Professional and technical services	53,234	10,261	31,024	26,838	10,438
62	Management of companies and enterprises	16,860	3,061	8,342	15,084	5,358
63	Administrative and waste services	20,247	6,666	13,296	13,887	5,257
66	Educational services	6,542	2,025	2,666	3,687	1,915
67	Health care and social assistance	40,536	19,005	30,964	38,115	19,541
71	Arts, entertainment, and recreation	5,738	3,590	3,685	3,478	1,742
75	Accommodation	3,858	1,042	2,034	1,579	1,304
77	Other services, except government	14,833	6,001	9,131	10,955	5,348
<b>Total of Service Related Industries</b>		<b>271,152</b>	<b>83,787</b>	<b>148,567</b>	<b>181,829</b>	<b>84,152</b>
<b>Total Gross Domestic Product</b>		<b>617,409</b>	<b>249,229</b>	<b>379,934</b>	<b>462,506</b>	<b>233,406</b>
<b>Services as % of GDP</b>		<b>43.92%</b>	<b>33.62%</b>	<b>39.10%</b>	<b>39.31%</b>	<b>36.05%</b>

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2007

**Table 3. Service Industries as a Percentage of GDP**

Industry Code	Industry	Illinois	Other Great Lake States	Difference
36	Transportation and warehousing, excluding Postal Service	3.6%	3.3%	0.2%
45	Information	3.5%	2.6%	0.9%
50	Finance and insurance	9.6%	6.9%	2.7%
57	Rental and leasing services and lessors of intangible assets	1.0%	0.7%	0.3%
58	Professional and technical services	8.6%	5.6%	3.0%
62	Management of companies and enterprises	2.7%	2.2%	0.5%
63	Administrative and waste services	3.3%	2.9%	0.4%
66	Educational services	1.1%	0.8%	0.3%
67	Health care and social assistance	6.6%	8.1%	-1.5%
71	Arts, entertainment, and recreation	0.9%	1.0%	0.0%
75	Accommodation	0.6%	0.5%	0.2%
77	Other services, except government	2.4%	2.4%	0.0%
<b>Total of Service Related Industries</b>		<b>43.9%</b>	<b>37.0%</b>	<b>6.9%</b>

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2007

## 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.

### Services Taxed Presently

Services of some sort are taxed in all fifty 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.

## 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
<b>ILLINOIS</b>	<b>12</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>1</b>	<b>1</b>	<b>17</b>	<b>47</b>
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
<b>Total</b>	<b>16</b>	<b>20</b>	<b>34</b>	<b>8</b>	<b>15</b>	<b>9</b>	<b>19</b>	<b>47</b>	<b>168</b>	
Average	56									
Median	55									

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. 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. The revenue collected from this tax is largely affected by weather. 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 \$309 million in FY 1999 to \$399 million in FY 2008. In FY 2009, the electricity excise tax amounted to \$393 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 2009, \$693.9 million was generated from the telecommunications excise tax of which \$593.3 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 \$171.5 million in FY 2009.

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

**Chart 3. Public Utility Tax Receipts - General Revenue**  
(FY 2005 - FY 2009)



**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).

In addition to this tax, 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 last service taxed by the State of Illinois is the short-term lease of automobiles. 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.

#### **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 2002 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 used as a base to estimate the individual sectors 2007 receipts using data from the U.S. Census Bureau's Annual Services report or state level GDP data, depending upon availability. These totals were then adjusted by subtracting the estimated proportion of those receipts that were thought to already be taxed. This adjustment was done to account for sales associated with parts or materials related to a service which are taxed under the Service Use Tax Act or for food that was prepared for immediate consumption, which are 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 \$7.25 billion. Potential income to local governments equaled \$1.81 billion. The majority of this potential revenue comes from four sectors. The largest sector is the Professional Services sector that accounts for \$2.3 billion or 32.2% of the total potential tax revenue. The second largest sector contributing to the estimate is the Business Services sector, which represents \$1.1 billion towards the estimate. These sectors are followed by the Construction sector and the Finance, Real Estate, and Insurance sector at \$803 million and \$732 million. The remaining sectors contribute

31.1%, or \$2.3 billion, of the total estimated potential tax revenue from taxing services. Totals for all the estimated sectors can be found in Table.

<b>Table 5. Broad Based Estimate</b>			
<b>Sector</b>	<b>Establishments</b>	<b>Est. 2007 Untaxed Revenue (\$1,000)</b>	<b>Potential Tax Revenue (\$1,000s)</b>
Agricultural Services	4,272	2,732,245	136,612
Industrial and Mining Services	355	402,107	20,105
Construction	19,479	16,055,662	802,783
Transportation Services	1,805	5,149,373	257,469
Storage	2,191	6,837,598	341,880
Utility Service	785	3,394,517	169,726
Finance, Insurance and Real Estate	8,031	14,638,142	731,907
Personal Services	8,998	6,552,522	327,626
Business Services	11,842	22,548,103	1,127,405
Computer Services	3,534	6,777,959	338,898
Automotive Services	870	656,755	32,838
Admissions & Amusements	2,603	7,083,740	354,187
Professional Services	31,425	46,676,449	2,333,822
Leases and Rentals	2,066	1,977,448	98,872
Fabrication, Installation and Repair Services	10,214	3,590,225	179,511
<b>Total</b>	<b>108,470</b>	<b>145,072,846</b>	<b>7,253,642</b>

Sources: Federation of Tax Administrators and Bureau of the Census

### *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 percent of total receipts that were accounted for by final use transactions, the potential income from each sector, and the total potential income from taxing these transactions. The final use percentages were generally used as listed in the table except in the case of health care related fields, which include dentists, medical test laboratories, nurse care facilities, and physicians. These fields were included in the Professional Services category in the service tax survey but would more appropriately be included in the personal services category of the final use data. As such, these sectors plus the media content related sectors of Computer services had a much higher final use rate of 96.3% instead of the 18.1% listed in Table 6.

This estimate totaled \$3.64 billion of potential revenue to the State. Local governments could expect to see an increase of \$910 million. The professional services sector continues to contribute the most to the estimate at over \$1.18 billion or 32.2%. Unlike the first estimate, the Business services sector contributes much less towards this estimate. In the first estimate this sector accounted for 15.5% of the total taxes collected. In this estimate they only account for 5.6% of the potential revenue. The construction sector, on the other hand, is much more important in this estimate. The

construction sector represents \$694 million, or 19.1%, of the total estimated revenue. Admissions and amusements are a bigger factor in this estimate at \$273 million.

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

<b>Table 6. Refined Estimate</b> (excludes business-to-business transactions)			
<b>Sector</b>	<b>Establishments</b>	<b>Service Related Receipts</b> (\$1,000)	<b>Potential Tax Revenue</b> (\$1,000s)
Agricultural Services	4,272	2,732,245	105,548
Industrial and Mining Services	355	402,107	21,853
Construction	19,479	16,055,662	688,331
Transportation Services	1,805	5,149,373	237,095
Storage	2,191	6,837,598	95,336
Utility Service	785	3,394,517	106,172
Finance, Insurance and Real Estate	8,031	14,638,142	533,926
Personal Services	8,998	6,552,522	246,181
Business Services	11,842	22,548,103	1,038,714
Computer Services	3,534	6,777,959	266,436
Automotive Services	870	656,755	29,640
Admissions & Amusements	2,603	7,083,740	251,431
Professional Services	31,425	46,676,449	1,826,506
Leases and Rentals	2,066	1,977,448	120,920
Fabrication, Installation and Repair Services	10,214	3,590,225	161,757
<b>Total</b>	<b>108,470</b>	<b>145,072,846</b>	<b>5,729,846</b>

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

### Comparisons between the 2006 and 2009 estimates

This report estimates that service related sales taxes could amount to between \$3.6 billion and \$7.3 billion per year. The estimate the Commission presented in the 2006 report was between \$2.2 billion and \$5.7 billion. This is a 26.6% increase of the broad based estimate and a 64.6% increase in the refined estimate. A significant portion of this change is related to natural growth of the economy. The Illinois service sector grew at a decent rate in the two new years of available data. The Illinois service sectors grew 6.5% in 2006 and 4.9% in 2007.

Two changes in methodology are responsible for the difference in the estimates beyond the natural growth of the two additional years of data. These changes in methodology include how the 2002 base data was estimated forward and changes in the application of final use percentages for the refined estimate. These changes were made to better refine the estimate at the individual service sector level.

The first change in methodology was the way in which the 2002 economic census data was estimated in later years. In the 2006 report, 2005 revenue data for each sector was

based on changes in the consumer price index applied to the 2002 economic census data. In this report, growth rates from the individual service sectors at the national level were used to estimate the growth in each industry in Illinois. This change led to a 35% increase in the revenue base compared to the 2006 report.

The other change in methodology is related to changes in final use percentages. This modification only applies to the refined estimate. The decision to change the healthcare related fields final use percentages from the Professional and business service final use rate to the Personal service final use rate added a significant amount to the refined estimate.

## 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 2.5 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 apposed 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 past 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. Similarly, groups such as the United States Chamber of Commerce would most likely be against this type of tax.



## **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 \$3.6 billion and \$7.3 billion. The growth in the service tax estimates from the 2006 report are mainly due to changes in revenue estimate methodology, natural growth in the service sector, and methodology changes related to the final use percentages of certain sectors. 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. 2007 Untaxed Revenue (\$1,000s)*	Broad Based Tax Revenue (\$1,000s)	Final Use %	Refined Base Tax Revenue (\$1,000s)**	States Taxing Service
<b>Agricultural Services</b>						
54194	Veterinary services (both large and small animal)	715,115	35,756	17.3%	6,200	5
81291	Pet grooming	78,180	3,909	17.3%	678	18
56173	Landscaping services (including lawn care)	1,938,950	96,947	17.3%	16,810	21
<b>Industrial and Mining Services</b>						
54136/213112	Oil Field Service / Seismograph & Geophysical Services	76,899	3,845	0.0%	0	10
323122	Typesetting service; platemaking for the print trade	325,208	16,260	0.0%	0	21
<b>Construction</b>						
237236	Gross Income of Construction Contractors	189,687	9,484	86.5%	8,207	12
238	Carpentry, painting, plumbing and similar trades.	15,865,975	793,299	86.5%	686,465	13
<b>Transportation Services</b>						
485	Income from intrastate transportation of persons	1,249,027	62,451	35.8%	22,331	11
492	Intrastate courier service	3,900,346	195,017	35.8%	69,732	7
<b>Storage</b>						
49313	Food storage	600,567	30,028	35.8%	10,737	10
49312	Fur storage/Cold storage	188,006	9,400	35.8%	3,361	16
49311	Household goods storage	5,430,858	271,543	35.8%	97,095	13
49319	Other warehousing & Storage (Household & Specialty Goods)	169,622	8,481	35.8%	3,033	N/A
53113	Mini -storage	153,717	7,686	35.8%	2,748	14
71393	Marina Service (docking, storage, cleaning, repair)	97,552	4,878	35.8%	1,744	17

## Appendix A. continued

NAICS Code	Services	Est. 2007 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)	96,103	4,805	35.8%	1,718	8
488991	Packing and crating	101,174	5,059	35.8%	1,809	10
<b>Utility Service</b>						
22132/562	Sewer and refuse, industrial and residential use	3,394,517	169,726	46.6%	79,047	15
<b>Finance, Insurance and Real Estate</b>						
52392/3	Investment counseling	7,243,232	362,162	54.4%	196,841	6
52231	Loan broker fees	1,069,792	53,490	54.4%	29,073	3
5312	Property sales agents (real estate or personal)	3,530,301	176,515	54.4%	95,939	5
5313	Real estate management fees (rental agents)	2,794,817	139,741	54.4%	75,952	5
<b>Personal Services</b>						
812111/2	Barber shops and beauty parlors	1,054,558	52,728	96.3%	50,777	7
56174	Carpet and upholstery cleaning	163,261	8,163	96.3%	7,861	19
81299	Other Personal Services (Dating, massage, and bail bond services)	284,180	14,209	96.3%	13,683	8
81221	Income from funeral services	523,844	26,192	96.3%	25,223	13
5619	Gift and package wrapping service	2,771,219	138,561	96.3%	133,434	21
81219	Health clubs, tanning parlors, reducing salons	267,551	13,378	96.3%	12,883	22
81231	Laundry and dry cleaning services, coin-op	203,218	10,161	96.3%	9,785	6
81232	Laundry and dry cleaning services, non-coin op	393,161	19,658	96.3%	18,931	22
56151	Travel agent services	695,281	34,764	96.3%	33,478	4
541921	Photographic studios, portrait	196,249	9,812	96.3%	9,449	N/A
<b>Business Services</b>						
	Sales of advertising time or space:					
54185	Billboards	343,626	17,181	18.0%	3,091	4
54184	Radio & television advertising	286,661	14,333	18.0%	2,578	2
54181	Advertising agency fees (not ad placement)	2,782,372	139,119	18.0%	25,026	11

## Appendix A. continued

NAICS Code	Services	Est. 2007 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	101,896	5,095	18.0%	916	16
56144	Check & debt collection	630,143	31,507	18.0%	5,668	8
54143	Commercial art and graphic design.	638,406	31,920	18.0%	5,742	23
812331	Commercial linen supply	113,167	5,658	18.0%	1,018	33
56145	Credit information, credit bureaus	710,706	35,535	18.0%	6,392	13
56131	Employment agencies	435,805	21,790	18.0%	3,920	11
54141	Interior design and decorating	286,779	14,339	18.0%	2,579	10
56172	Maintenance and janitorial services	2,222,092	111,105	18.0%	19,986	19
541613	Marketing (Marketing Consulting Service)	1,342,334	67,117	18.0%	12,073	6
56171	Exterminating (includes termite services)	227,114	11,356	18.0%	2,043	21
561439	Photocopying services	142,163	7,108	18.0%	1,279	43
32311	Printing	4,110,663	205,533	18.0%	36,973	45
561611	Private investigation (detective) services	178,896	8,945	18.0%	1,609	16
54182	Public relations, management consulting	394,394	19,720	18.0%	3,547	7
56141/561492	Secretarial and court reporting services	203,650	10,183	18.0%	1,832	8
561612	Security services	707,489	35,374	18.0%	6,363	18
54189	Sign construction and installation	725,991	36,300	18.0%	6,530	31
561422	Telemarketing services on contract	449,367	22,468	18.0%	4,042	6
561421	Telephone answering service	66,238	3,312	18.0%	596	20
56132	Temporary help agencies	4,454,352	222,718	18.0%	40,064	10
54138	Test laboratories (excluding medical)	742,358	37,118	18.0%	6,677	8
326212	Tire Recapping	37,998	1,900	18.0%	342	28
56179	Other services to buildings & dwellings	213,440	10,672	18.0%	1,920	19
<b>Computer Services</b>						
541511	Software - modifications to canned program	3,628,682	181,434	18.0%	32,638	29
518111	Internet Service Providers	258,551	12,928	18.0%	2,325	12
519190	Information services	42,145	2,107	18.0%	379	13
518210	Data processing services	2,720,567	136,028	18.0%	24,470	9

## Appendix A. continued

NAICS Code	Services	Est. 2007 Untaxed Revenue (\$1,000s)*	Broad Based Tax Revenue (\$1,000s)	Final Use %	Refined Base Tax Revenue (\$1,000s)**	States Taxing Service
	Books - Downloaded	1,065	53	96.3%	51	15
	Music - Downloaded	84,348	4,217	96.3%	4,061	15
	Movies/Digital Vidoe - Downloaded	42,600	2,130	96.3%	2,051	16
<b>Automotive Services</b>						
81293	Parking lots & garages	457,501	22,875	64.3%	14,717	21
48841	Motor vehicle towing	199,254	9,963	64.3%	6,409	19
<b>Admissions &amp; Amusements</b>						
71311	Amusement park admission & rides	159,100	7,955	77.0%	6,125	36
71399	Billiard parlors	337,312	16,866	77.0%	12,987	27
71395	Bowling alleys	228,396	11,420	77.0%	8,793	27
7113	Circuses and fairs -- admission and games	571,192	28,560	77.0%	21,991	34
71312	Coin operated video games / Pinball machines	59,406	2,970	77.0%	2,287	19
71391	Membership fees in private clubs.	764,035	38,202	77.0%	29,416	23
7112	Admission to spectator sports (excluding horse tracks)	1,217,912	60,896	77.0%	46,890	22
51213	Motion picture theatres	385,307	19,265	77.0%	14,834	N/A
5175	Cable & other program distribution*	2,930,880	146,544	77.0%	112,840	25
7111	Admission to cultural events	430,201	21,510	77.0%	16,563	31
<b>Professional Services</b>						
5412	Accounting and bookkeeping	6,405,809	320,290	18.0%	57,616	5
54131	Architects	1,746,910	87,346	18.0%	15,712	5
5411	Attorneys	14,710,821	735,541	18.0%	132,314	5
6212	Dentists	3,131,788	156,589	96.3%	150,796	4
54133	Engineers	4,147,525	207,376	18.0%	37,304	5
54137	Land surveying	178,821	8,941	18.0%	1,608	7
6215	Medical test laboratories	1,004,604	50,230	96.3%	48,372	4
62311	Nursing care facilities	3,240,669	162,033	96.3%	156,038	4
6211	Physicians	12,109,502	605,475	96.3%	583,073	4

**Appendix A. continued**

<b>NAICS Code</b>	<b>Services</b>	<b>Est. 2007 Untaxed Revenue (\$1,000s)*</b>	<b>Broad Based Tax Revenue (\$1,000s)</b>	<b>Final Use %</b>	<b>Refined Base Tax Revenue (\$1,000s)**</b>	<b>States Taxing Service</b>
<b>Leases and Rentals</b>						
5322	Personal property	1,062,299	53,115	54.4%	28,869	45
532112	Long term automobile lease	527,109	26,355	54.4%	14,325	40
5323	General rental centers	190,614	9,531	54.4%	5,180	N/A
48121	Chartered flights (with pilot)	141,873	7,094	54.4%	3,856	9
7212	Trailer parks - overnight	55,553	2,778	54.4%	1,510	29
<b>Fabrication, Installation and Repair Services</b>						
811	Labor charges - repairs other tangible property	3,590,225	179,511	64.3%	115,487	24
<b>Total</b>		<b>145,072,846</b>	<b>7,253,642</b>		<b>3,639,715</b>	
N/A = Data Not Available						
Source: Sales Taxation of Services - 2007 Update, Federation of Tax Administrators; 2002 and 1997 Economic Census, 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 "Bonded Indebtedness Report" examines the State's debt position as well as other issues directly related to conditions in the financial markets. 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>