

Service Taxes

History, Issues, and Estimates

Commission on Government
Forecasting and Accountability
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Forecasting and Accountability

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EXECUTIVE SUMMARY

This report represents a preliminary investigation by the Commission on the topic of service taxes. 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 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 2005, consumers spent over \$5.1 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. By 1997, the service industries accounted for \$167 billion, or 41.3%, of Illinois' \$404 billion economy.
- 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 has been a piecemeal process over the past fifteen 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 services are taxed in the U.S.

- Hawaii is the state that taxes the most services at 160, followed by Washington (157), New Mexico (156), South Dakota (146), and Delaware (143). Illinois taxes 17 services, while the average state taxes 55.
- 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 \$5.7 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 \$2.2 billion in potential revenue was estimated after excluding business-to-business transactions.
- 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

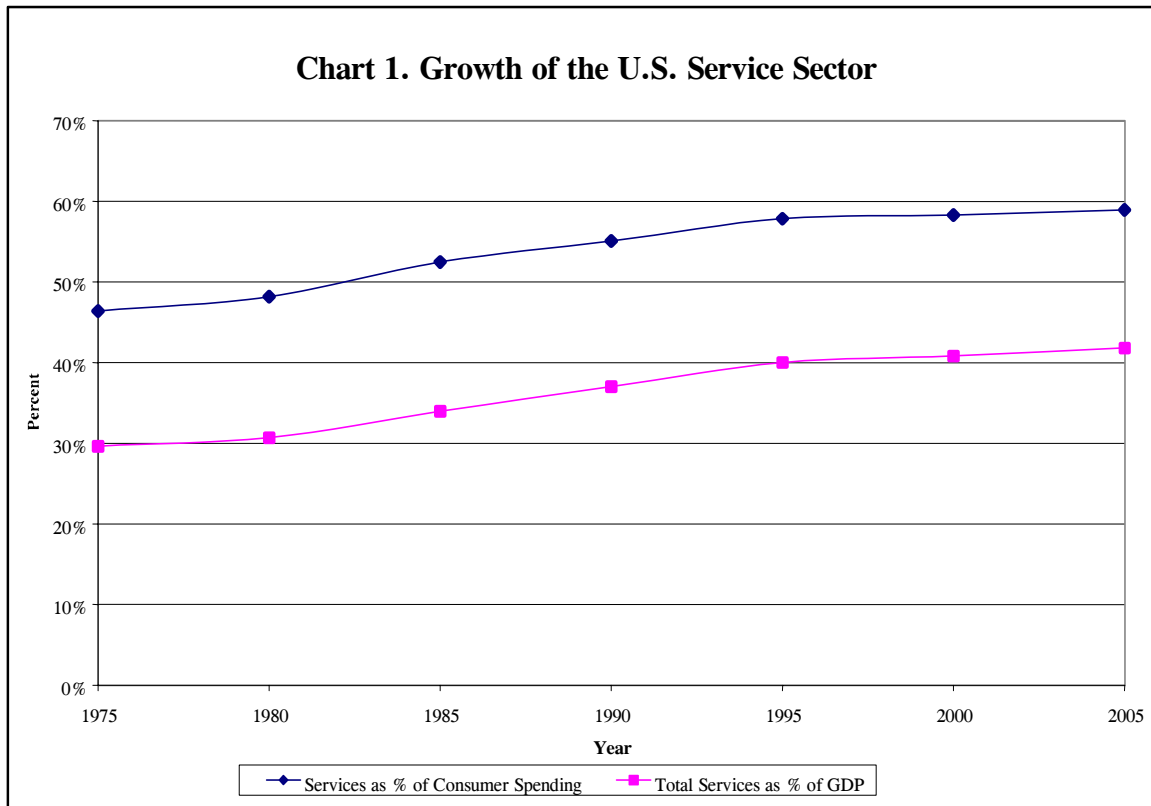
Service related sectors have become more prominent to both the U.S. and the Illinois economy. As manufacturing related sectors have outsourced more of their work to foreign countries, service related sectors have become a larger part of the economy. This is most likely due to the fact that services often 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 2005, consumers spent over \$5.1 trillion on services and over \$8.7 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 2005, the GDP was \$12.5 trillion with \$5.2 trillion or 41.8% 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.

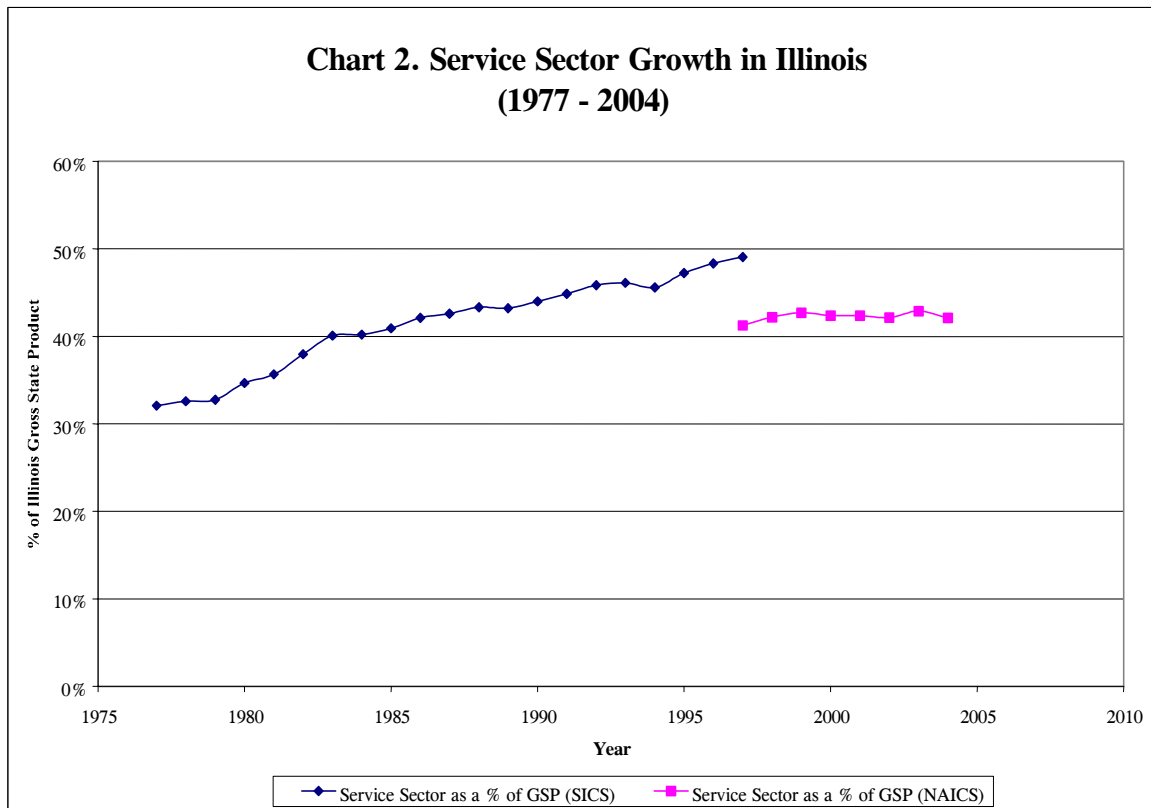
Year	Consumer Spending on Services (\$ Billion)	Total Consumer Spending (\$ Billion)	Services as % of Consumer Spending	Service Exports (\$ Billion)	Gross Domestic Product (\$ Billion)	Total Services as % of GDP
1975	480.2	1,034.4	46.4	5.4	1,638.3	29.6
1980	846.9	1,757.1	48.2	9.7	2,789.5	30.7
1985	1,428.1	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	5,155.1	8,746.2	58.9	68.8	12,485.7	41.8



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 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 \$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 GSP. Using this method, service industries accounted for \$167 billion or 41.3% of Illinois' \$404 billion GSP in 1997. Using the NAICS system, service industries have been consistently around 42% of the State's GSP. In 2004, Illinois had a GSP of \$522 billion of which approximately \$220 billion 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 2002 (the last year with data from all surveyed industries), comparisons from state to state can be made for the Great Lakes region. In 2002, Illinois’ service related industries comprised 42.2% of the states GSP. This is the highest of the Great Lake States. Secondary in the region is Ohio at 36.0%, followed by Michigan (35.7%), Wisconsin (33.5%), and Indiana (31.2%). The other Great Lake States service sectors averaged 34.1% of their GSP.

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. Health Care and Social Assistance accounts for 6.3% of the State’s GSP, while the industry averages 7.4% of the other state’s economy. 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	17,151	6,883	8,450	11,233	5,949
45	Information	19,305	4,454	9,242	10,825	5,461
50	Finance and insurance	45,176	11,474	20,013	27,770	12,807
57	Rental and leasing services and lessors of intangible assets	5,245	1,778	2,315	3,359	1,058
58	Professional and technical services	39,858	7,453	27,489	20,496	7,798
62	Management of companies and enterprises	9,650	2,247	7,351	8,776	3,458
63	Administrative and waste services	13,829	4,923	10,995	10,289	3,889
66	Educational services	4,575	1,434	1,772	2,714	1,391
67	Health care and social assistance	30,815	14,283	23,747	29,581	14,891
71	Arts, entertainment, and recreation	4,579	2,767	3,067	2,934	1,405
75	Accommodation	2,741	825	1,403	1,348	1,032
77	Other services, except government	12,051	4,817	7,952	9,549	4,342
	Total of Service Related Industries	204,975	63,338	123,796	138,874	63,481
	Total Gross State Product	486,182	203,296	347,014	385,657	189,508
	Services as % of GSP	42.16%	31.16%	35.67%	36.01%	33.50%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2002

Table 3. Service Industries as a Percentage of Gross State Product

Industry Code	Industry	Illinois	Other Great Lake States	Difference
36	Transportation and warehousing, excluding Postal Service	3.5%	3.0%	0.6%
45	Information	4.0%	2.6%	1.3%
50	Finance and insurance	9.3%	6.3%	2.9%
57	Rental and leasing services and lessors of intangible assets	1.1%	0.7%	0.3%
58	Professional and technical services	8.2%	5.3%	2.9%
62	Management of companies and enterprises	2.0%	1.8%	0.2%
63	Administrative and waste services	2.8%	2.6%	0.3%
66	Educational services	0.9%	0.7%	0.3%
67	Health care and social assistance	6.3%	7.3%	-1.0%
71	Arts, entertainment, and recreation	0.9%	0.9%	0.0%
75	Accommodation	0.6%	0.4%	0.1%
77	Other services, except government	2.5%	2.4%	0.1%
	Total of Service Related Industries	42.2%	34.1%	8.1%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2002

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. Analyzing the data collected by the Federation of Tax Administrators in their "Sales

Taxation of Services” survey, as of July 2004, 168 different services were taxed in the United States and the District of Columbia. The state that taxes the most services is Hawaii, which taxes 160 different service categories. Washington, which taxes 157 services, and New Mexico, which taxes 156, closely follows Hawaii. The only other states to tax more than 100 different services are: South Dakota (146), Delaware (143), and West Virginia (110). The state with the least amount of service taxes is Oregon, which does not tax any services. The average and median is 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. Only four states do not tax this category. Another leading category was Business Services, which was taxed by 33 states and the District of Columbia. Other categories with numerous states taxing were Personal Services (20), 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, 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 23 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 74 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	Repair and Installation	Other Services	Total	State Ranking
Alabama	12	2	6	3	10	0	1	3	37	27
Alaska /1	0	0	0	0	0	0	0	1	1	49
Arizona	12	2	5	1	11	0	2	25	58	20
Arkansas	16	7	12	1	12	0	11	13	72	13
California	4	2	7	2	1	0	3	4	23	40
Colorado /1	4	0	2	1	2	0	3	2	14	47
Connecticut	10	9	20	6	10	0	11	14	80	9
Delaware /2	9	20	33	6	10	9	19	37	143	5
Dist. of Columbia	12	8	11	8	7	0	13	11	70	NA
Florida /r	7	4	8	0	14	0	16	13	62	18
Georgia	10	4	5	2	8	0	1	6	36	28
Hawaii	16	20	34	8	14	9	18	41	160	1
Idaho	0	3	5	0	11	0	6	5	30	31
Illinois	12	1	1	1	0	0	1	1	17	45
Indiana	7	4	3	2	3	0	0	4	23	40
Iowa	13	15	18	1	13	0	14	20	94	7
Kansas	7	10	9	1	13	0	16	15	71	14
Kentucky	11	2	4	2	6	0	3	1	29	33
Louisiana	10	8	5	3	9	0	13	7	55	23
Maine	9	1	6	0	2	0	4	2	24	39
Maryland	5	3	13	1	11	0	4	2	39	26
Massachusetts	9	1	4	0	1	0	2	2	19	42
Michigan	12	2	7	1	1	0	1	2	26	38
Minnesota	15	7	12	2	14	0	6	11	67	16
Mississippi	10	5	8	3	11	0	14	23	74	11
Missouri	8	1	2	2	11	0	0	4	28	36
Montana	12	0	0	0	3	0	0	4	19	42
Nebraska	14	8	15	3	12	0	13	11	76	10
Nevada	0	1	3	0	7	0	1	3	15	46
New Hampshire	6	1	0	2	0	0	0	2	11	48
New Jersey	10	2	10	0	6	0	14	13	55	23
New Mexico	16	20	32	8	14	9	18	39	156	3
New York	4	4	13	1	5	0	14	15	56	22
North Carolina	10	5	5	0	8	0	1	1	30	31
North Dakota	6	1	4	2	11	0	1	2	27	37
Ohio	8	12	14	5	3	0	12	14	68	15
Oklahoma	8	3	4	2	10	0	0	5	32	30
Oregon	0	0	0	0	0	0	0	0	0	50
Pennsylvania	9	6	16	1	1	0	14	8	55	23
Rhode Island	10	1	6	3	4	0	3	2	29	33
South Carolina	4	6	6	4	10	0	1	3	34	29
South Dakota	14	19	28	8	13	5	18	41	146	4
Tennessee	11	10	7	3	12	0	13	11	67	16
Texas	12	10	14	8	12	1	11	13	81	8
Utah	7	8	6	0	10	0	15	11	57	21
Vermont	6	2	5	2	11	0	2	1	29	33
Virginia	1	3	4	0	1	0	4	5	18	44
Washington /2	16	20	33	8	12	9	16	43	157	2
West Virginia /1	10	17	26	4	13	1	13	26	110	6
Wisconsin	11	11	7	3	14	0	14	14	74	11
Wyoming	10	6	7	3	7	0	16	13	62	18
Total	16	20	34	8	15	9	19	47	168	

Average 55

Median 55

Source: Federal of Tax Administrators, Sales Taxation of Services, 2004/1. 1996 data. /2. Includes the business license tax in Delaware and the business occupation tax in Washington. /r data revised.

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 in this State, 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, most of 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 \$293 million in FY 1995 to \$351 million in FY 2000. In 2005, revenue from the electricity excise tax totaled \$348 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.

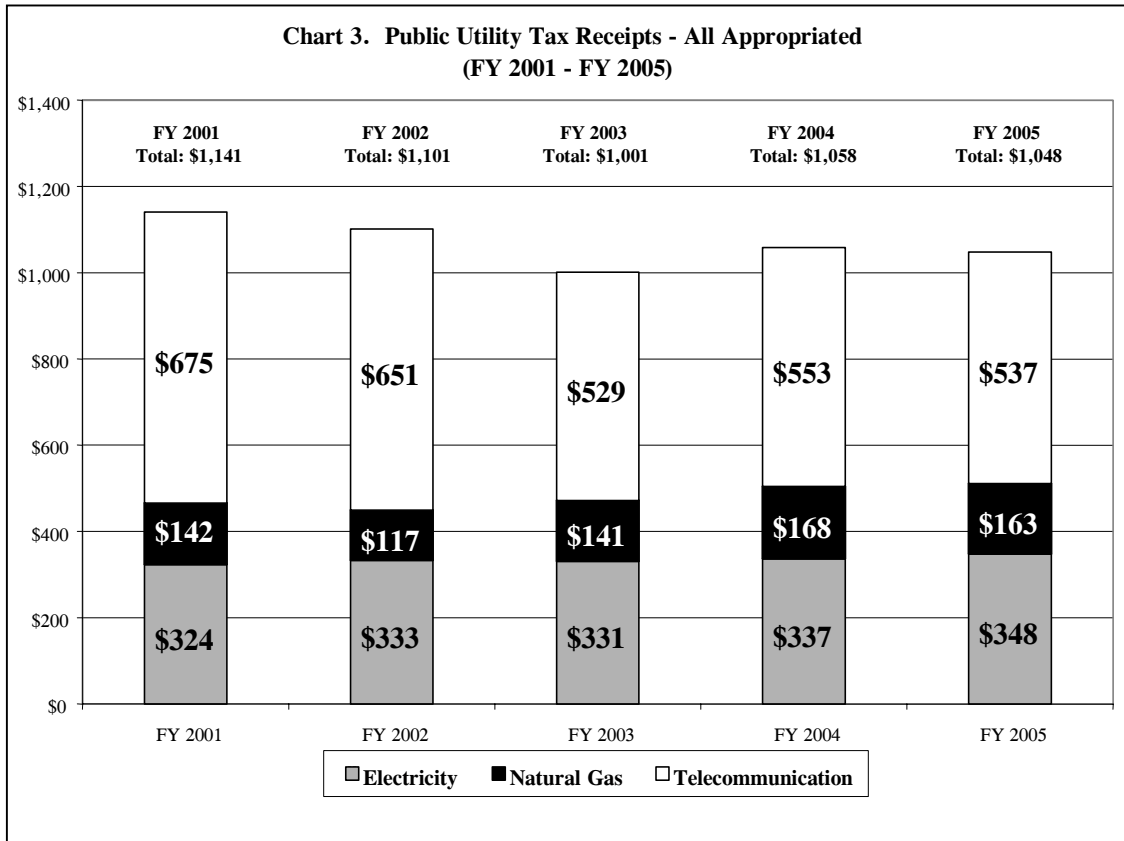
The rate and base of the telecommunications excise tax is simple: 7% of gross charges by businesses for transmitting messages in interstate or intrastate commerce. In 2005, \$628.8 million was generated from the telecommunications excise tax of which \$537 million went into the General Revenue Fund.

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 2005, the State collected \$163 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.

Total 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. 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.

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 2005, the Hotel Operator's Occupation Tax had receipts of \$165.1 million. Of this \$165.1 million, \$53.6 million went to the Build Illinois Fund, \$31.0 million was transferred to MPEA, \$28 million went to the Illinois Sports Facilities Fund, \$12.9 million was distributed to the Local Tourism Fund, and \$7.2 million went to the International Tourism Fund. The remaining \$32.4 million was distributed to 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 2005, the State collected \$28.1 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 2002. These receipts were adjusted to 2005 dollars using Consumer Price Index (CPI) data. These totals were then adjusted by subtracting the estimated proportion of those receipts that were associated with parts or materials related to the service. This was done because parts and materials are already taxed under the Service Use 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 end consumers. 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 resulting 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 \$5.7 billion. Potential income to local governments equaled \$1.4 billion. The majority of this potential revenue comes from four sectors. The largest sector is the Professional Services sector that accounts for \$1.8 billion or 31.9% of the total potential tax revenue. The second largest sector contributing to the estimate is the Business Services sector, which represents \$1.0 billion towards the estimate. These sectors are followed by the Construction sector and the Finance, Real Estate, and Insurance sector at \$688 million and \$534 million. The remaining sectors contribute 28.7%, or \$1.6 billion, of the total estimated potential tax revenue from taxing services. Totals for all the estimated sectors can be found in Table 5 on the following page.

Detailed information on this estimate, including the number of service providers in Illinois and the number of states taxing each service, can be found in Appendix A.

Table 5. Broad Based Estimate, breakdown by sector

Sector	Establishments	Service Related Receipts (\$1,000)	Potential Tax Revenue (\$1,000s)
Agricultural Services	4,272	2,110,957	105,548
Industrial and Mining Services	355	437,057	21,853
Construction	19,479	13,766,626	688,331
Transportation Services	1,805	4,741,907	237,095
Storage	2,191	1,906,712	95,336
Utility Service	785	2,123,438	106,172
Finance, Insurance and Real Estate	8,031	10,678,518	533,926
Personal Services	8,998	4,923,629	246,181
Business Services	11,842	20,774,282	1,038,714
Computer Services	3,534	5,328,727	266,436
Automotive Services	870	592,793	29,640
Admissions & Amusements	2,603	5,028,619	251,431
Professional Services	31,425	36,530,115	1,826,506
Leases and Rentals	2,066	2,418,398	120,920
Fabrication, Installation and Repair Services	10,214	3,235,140	161,757
Total	108,470	114,596,917	5,729,846

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 total of these transactions, the potential income from each sector, and the total potential income from taxing these transactions.

This estimate totaled \$2.2 billion of potential revenue to the State. Local governments could expect to see an increase of \$553 million. Unlike the first estimate, the Professional services and Business services sectors contribute much less towards this estimate. In the first estimate these two sectors accounted for over 50% of the total taxes collected. In this estimate they only account for 23.45% of the potential revenue. The construction sector, on the other hand, is much more important in this estimate. The construction sector represents \$610 million, or 27.57%, of the total estimated revenue. Admissions and amusements are a bigger factor in this estimate at \$195 million.

Table 6. Refined Estimate (excludes business-to-business transactions), breakdown by sector

Sector	End Use Sales %	End Use Sales (\$1,000s)	Potential Tax Revenue (\$1,000s)
Agricultural Services	15.2%	319,810	15,990
Industrial and Mining Services	0.0%	0	0
Construction	88.6%	12,195,854	609,793
Transportation Services	34.9%	1,652,554	82,628
Storage	34.9%	664,489	33,224
Utility Service	46.6%	988,673	49,434
Finance, Insurance and Real Estate	56.5%	6,035,498	301,775
Personal Services	65.9%	3,244,179	162,209
Business Services	18.1%	3,762,222	188,111
Computer Services	18.1%	965,032	48,252
Automotive Services	65.9%	390,591	19,530
Admissions & Amusements	77.7%	3,905,728	195,286
Professional Services	18.1%	6,615,604	330,780
Leases and Rentals	56.5%	1,366,879	68,344
Fabrication, Installation and Repair Services	65.9%	2,131,634	106,582
Total		44,238,749	2,211,937

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 cost 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 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 passed 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 \$2.2 billion and \$5.7 billion. 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 using All Potential Services

NAICS Code	Services	Service Providers	Estimated 2005 Service Revenue (\$1,000s)	Potential Tax Revenue @ 5% (\$1,000s)	States Taxing Service
Agricultural Services					
54194	Veterinary services (both large and small animal)	893	553,139	27,657	5
81291	Pet grooming	396	54,846	2,742	18
56173	Landscaping services (including lawn care)	2,983	1,502,972	75,149	20
Industrial and Mining Services					
54136/213112	Seismograph & Geophysical Services	112	55,382	2,769	6
213112	Oil Field Services	105	41,513	2,076	10
323122	Typesetting service; platemaking for the print trade	138	340,162	17,008	20
Construction					
238	Carpentry, painting, plumbing and similar trades.	19,479	13,766,626	688,331	13
Transportation Services					
485	Income from intrastate transportation of persons	849	1,083,759	54,188	11
492	Intrastate courier service	509	3,295,433	164,772	6
4853	Taxi & Limousine service	402	251,756	12,588	8
481211	Nonscheduled chartered passenger air transportation	45	110,959	5,548	0
Storage					
49313	Food storage	37	52,334	2,617	9
49312	Fur storage/Cold storage	37	183,502	9,175	16
49311	Household goods storage	430	636,906	31,845	13
49319	Other warehousing & Storage (Household & Specialty Goods)	103	110,111	5,506	0
53113	Mini -storage	273	133,378	6,669	13

Appendix A. continued

NAICS Code	Services	Service Providers	Estimated 2005 Service Revenue (\$1,000s)	Potential Tax Revenue @ 5% (\$1,000s)	States Taxing Service
71393	Marina Service (docking, storage, cleaning, repair)	100	84,644	4,232	18
48833	Marine towing service (incl. tugboats)	29	83,387	4,169	8
56151	Travel agent services	1,182	622,452	31,123	3
Utility Service					
22132/562	Sewer and refuse, industrial and residential use	785	2,123,438	106,172	14
Finance, Insurance and Real Estate					
52392/3	Investment counseling	1,340	4,262,085	213,104	6
52231	Loan broker fees	768	928,240	46,412	4
5312	Property sales agents (real estate or personal)	2,988	3,063,180	153,159	5
5313	Real estate management fees (rental agents)	2,935	2,425,013	121,251	5
Personal Services					
812111/2	Barber shops and beauty parlors	3,186	865,190	43,260	7
56174	Carpet and upholstery cleaning	376	124,989	6,249	18
8129902	Dating services	45	14,975	749	8
812331	Diaper service	41	122,874	6,144	23
81221	Income from funeral services	857	513,777	25,689	14
5619	Gift and package wrapping service	1,154	2,223,747	111,187	21
81219	Health clubs, tanning parlors, reducing salons	582	157,833	7,892	21
81231	Laundry and dry cleaning services, coin-op	618	217,078	10,854	6
81232	Laundry and dry cleaning services, non-coin op	1,255	373,156	18,658	23
812199	Massage services	496	109,718	5,486	10
56179	Other services to buildings & dwellings	307	122,745	6,137	17
5619902	Water softening and conditioning	81	77,546	3,877	13

Appendix A. continued

NAICS Code	Services	Service Providers	Estimated 2005 Service Revenue (\$1,000s)	Potential Tax Revenue @ 5% (\$1,000s)	States Taxing Service
Business Services					
	Sales of advertising time or space:				
54185	Billboards	123	233,487	11,674	5
54184	Radio & television advertising	185	319,774	15,989	4
54181	Advertising agency fees (not ad placement)	680	2,068,466	103,423	11
561613	Armored car services	23	118,232	5,912	15
8129901	Bail bond fees	127	26,772	1,339	4
56144	Check & debt collection	196	498,565	24,928	8
54143	Commercial art and graphic design.	1,111	568,671	28,434	21
812331	Commercial linen supply	41	122,874	6,144	32
56145	Credit information, credit bureaus	44	416,949	20,847	12
56131	Employment agencies	491	370,248	18,512	10
54141	Interior design and decorating	582	193,800	9,690	10
56172	Maintenance and janitorial services	2,238	1,783,123	89,156	19
56171	Exterminating (includes termite services)	301	185,139	9,257	20
561439	Photocopying services	266	376,922	18,846	43
32311	Printing	1,922	7,133,499	356,675	45
561611	Private investigation (detective) services	203	123,845	6,192	14
56141/561492	Secretarial and court reporting services	422	181,471	9,074	8
561612	Security services	260	848,279	42,414	16
54189	Sign construction and installation	457	559,637	27,982	29
561422	Telemarketing services on contract	148	400,701	20,035	6
561421	Telephone answering service	78	74,341	3,717	19
56132	Temporary help agencies	1,421	3,514,990	175,750	11
54138	Test laboratories (excluding medical)	216	501,065	25,053	8
56179	Window cleaning	307	153,431	7,672	18
Computer Services					
541511	Software - modifications to canned program	2,785	2,968,809	148,440	30
518111	Internet Service Providers	167	206,626	10,331	15
519190	Information services	10	32,797	1,640	12

Appendix A. continued

NAICS Code	Services	Service Providers	Estimated 2005 Service Revenue (\$1,000s)	Potential Tax Revenue @ 5% (\$1,000s)	States Taxing Service
518210	Data processing services	572	2,120,495	106,025	11
Automotive Services					
81293	Parking lots & garages	578	456,955	22,848	20
48841	Motor vehicle towing	292	135,837	6,792	0
Admissions & Amusements					
71311	Amusement park admission & rides	10	131,367	6,568	37
71399	Billiard parlors	508	271,920	13,596	27
71395	Bowling alleys	299	203,897	10,195	27
7113	Circuses and fairs -- admission and games	208	400,397	20,020	34
71312	Coin operated video games / Pinball machines	109	62,831	3,142	18
71391	Membership fees in private clubs.	509	753,641	37,682	22
7112	Admission to spectator sports (excluding horse tracks)	186	783,632	39,182	22
487	Scenic & sightseeing transportation*	45	59,266	2,963	0
512131	Motion picture theatres	197	273,423	13,671	0
5175	Cable & other program distribution*	151	1,656,187	82,809	25
7111	Admission to cultural events	381	432,058	21,603	33
Professional Services					
5412	Accounting and bookkeeping	4,878	4,823,463	241,173	5
54131	Architects	1,140	1,195,517	59,776	5
5411	Attorneys	7,878	11,431,398	571,570	5
6212	Dentists	5,488	2,583,369	129,168	4
54133	Engineers	1,949	3,049,349	152,467	5
541921	Photographic studios, portrait	680	181,482	9,074	0
54137	Land surveying	201	128,785	6,439	7
6215	Medical test laboratories	352	803,265	40,163	4
62311	Nursing care facilities	746	2,876,729	143,836	4
6211	Physicians	8,113	9,456,759	472,838	4

Appendix A. continued

NAICS Code	Services	Service Providers	Estimated 2005 Service Revenue (\$1,000s)	Potential Tax Revenue @ 5% (\$1,000s)	States Taxing Service
Leases and Rentals					
5322	Personal property	1,440	1,000,588	50,029	45
532111	Short term automobile rental	127	669,635	33,482	48
532112	Long term automobile lease	49	418,117	20,906	38
5323	General rental centers	243	158,755	7,938	0
48121	Chartered flights (with pilot)	58	123,101	6,155	11
7212	Trailer parks - overnight	149	48,202	2,410	29
Fabrication, Installation and Repair Services					
811	Labor charges - repairs other tangible property	10,214	3,235,140	161,757	24
Total		108,470	114,596,917	5,729,846	
* Data was taken from 1997 economic census					
Source: Sales Taxation of Services - 2004 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 "Illinois Bond Watcher" 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:

Commission on Government Forecasting and Accountability
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http://www.ilga.gov/commission/cgfa/cgfa_home.html