

ILLINOIS CONSUMPTION TAXES

Consumption taxes are the second-most widely used source of tax revenue—and the most regressive major revenue source—in Illinois. General sales taxes and specialized excise taxes represented just under a third of all Illinois state and local tax revenues in 1999. Yet the ability of these taxes to support future needs seems likely to decline in future years unless base-broadening reforms are enacted: the Illinois sales tax base, one of the narrowest in the nation, exempts most sales of personal, professional and business services—the fastest-growing areas of personal consumption—and the state's narrow base and high tax rate result in an inequitable tax. And despite a series of regressive excise tax increases in recent years, the yield of the state's excise taxes is likely to decline further unless policy makers continue to raise the rates on these taxes.

The Total Illinois Consumption Tax Burden

The Illinois sales and excise tax burden is lower than the national average. In fiscal year 1999, Illinois sales and excise taxes amounted to 3.3 percent of personal income—ranking 36th nationally, and just 87 percent of the national average. The Illinois consumption tax burden is also lower than that of all neighboring states by this measure. Moreover, the state's consumption tax burden has decreased since 1979 relative to the national average—and relative to other Midwestern states.

However, the state's reliance on one category of consumption tax—selective sales and excise taxes on particular items—is actually somewhat *higher* than the national average. While the state's general sales tax burden is 31 percent below the national average, the Illinois excise tax burden is 17 percent higher than the U.S. average.

As a result, Illinois derives an unusually high percentage of its consumption tax revenues—43 percent in fiscal 1999, well above the national average of 31 percent—from excise taxes on particular items such as cigarettes, gasoline and

Trends in Illinois Consumption Taxes

	As a % of Personal Income				As % of Total Taxes			
	1978	US Rank	1999	US Rank	1978	US Rank	1999	US Rank
Illinois	3.9%	25	3.3%	36	38.4%	24	32.6%	29
Indiana	3.8%	28	3.1%	39	40.9%	20	30.5%	35
Iowa	2.7%	45	3.5%	33	26.7%	43	33.4%	28
Kentucky	4.2%	21	4.0%	22	41.6%	19	36.6%	22
Michigan	3.0%	42	3.4%	34	27.4%	42	31.3%	33
Missouri	3.8%	27	4.0%	21	42.6%	18	39.9%	19
Wisconsin	3.2%	39	3.6%	29	25.9%	44	0	37
ALL STATES	3.9%		3.8%		34.9%		35.7%	
IL/ US avg	101%		87%		110%		91%	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

alcoholic beverages, and a relatively small percentage of its consumption tax revenue from its state and local general sales taxes. This imbalance is largely a product of the narrowness of the state sales tax base—and the state's willingness to frequently increase excise taxes.¹⁸

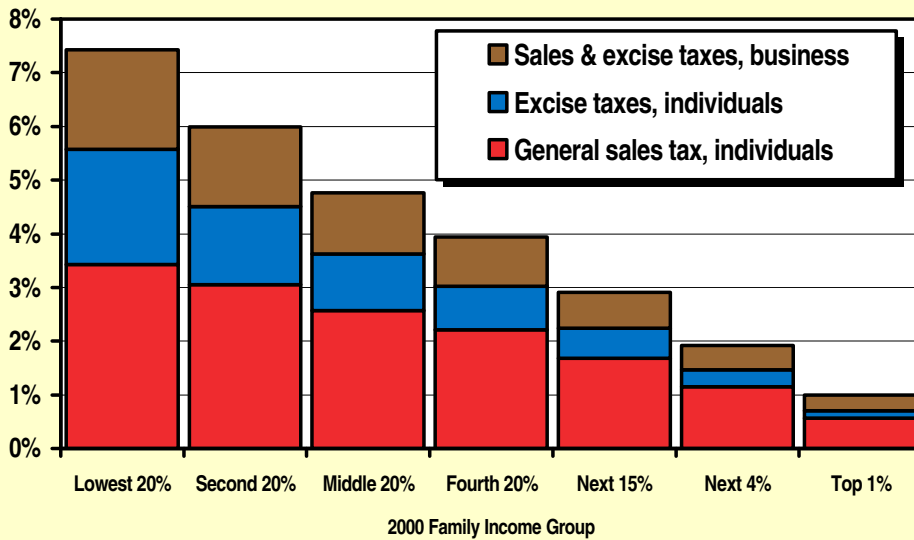
The Most Regressive Tax

Consumption taxes are inherently regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. Typically, low-income families spend three-quarters of their income on items subject to sales tax, middle-income families spend about half their income on items subject to the sales tax, and the wealthiest taxpayers spend less than a sixth of their income on such items. The distributional impact of Illinois consumption taxes reflects this pattern:

- The poorest twenty percent of Illinoisans—those earning less than \$15,000—paid 7.4 percent of their income in consumption taxes in 2000.

¹⁸Many states include utility gross receipts in the sales tax base rather than taxing these receipts separately. For this reason, it is most meaningful to use the collective burden of sales and excise taxes as the basis for comparisons between states.

Illinois Consumption Taxes As Shares of 2000 Family Income



- Illinoisans in the middle of the income distribution paid an average of 4.8 percent of their income in consumption taxes.
- The wealthiest one percent of taxpayers paid an effective consumption tax rate of 1.0 percent in 2000.

This means that low-income Illinoisans pay more than seven times the effective sales and excise tax rate that the wealthy pay. Put another way, the Illinois consumption tax structure is equivalent to an income tax with a 7.4 percent rate for the poor, a 4.8 percent rate for the middle class, and a 1 percent rate for the wealthiest Illinois taxpayers. Obviously, no one would intentionally design an income tax that looks like this—yet by relying on consumption taxes as a revenue source, this is effectively the choice Illinois policy makers have made. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in an innocuous looking single rate and that the amount families pay is hidden in many small purchases throughout the year.

A High-Rate Tax

The Illinois general sales tax was introduced in 1933, with a tax rate of 2 percent, as a response to Depression-induced revenue shortfalls. The statewide rate in 2001 is 6.25 percent, with a special reduced rate of 1 percent on groceries, prescription and nonprescription medicines, drugs, and various medical supplies and equipment. The Illinois sales tax rate is quite high relative to most

other states: the statewide rate of 6.25 percent is the sixth-highest among the 45 states currently levying state sales taxes, and second only to Minnesota among neighboring states.

Illinois localities were first allowed to levy general sales taxes in 1955. By the late 1980s, local taxing authority had been granted so widely that a confusing array of local tax rates and tax bases had sprung up. In addition to the 5 percent state rate, most localities were levying and collecting an additional 1.25 percent in local taxes, with additional taxes in many home rule districts. The variety of tax rates—and tax

bases—was an administrative nightmare for taxpayers and tax collectors. Legislation enacted in 1988 simplified and centralized the tax collection procedure. In 1990, the state began collecting not just the 5 percent state tax rate, but also two county sales taxes (a 1 percent tax and a 0.25 percent tax), and also administered the home rule taxes that were levied at the time. In addition to centralizing tax collections, the 1990 reforms also required a uniform tax base for each type of local sales tax.

Since the reforms were implemented in 1990, the uniformity of the tax base has made the sales tax administratively easier to pay and collect. Yet the variety of local option sales taxes available to localities has meant that the sales tax burden on low- and middle-income Illinoisans has grown steadily higher. A series of enabling laws has allowed localities to enact these taxes for various purposes:

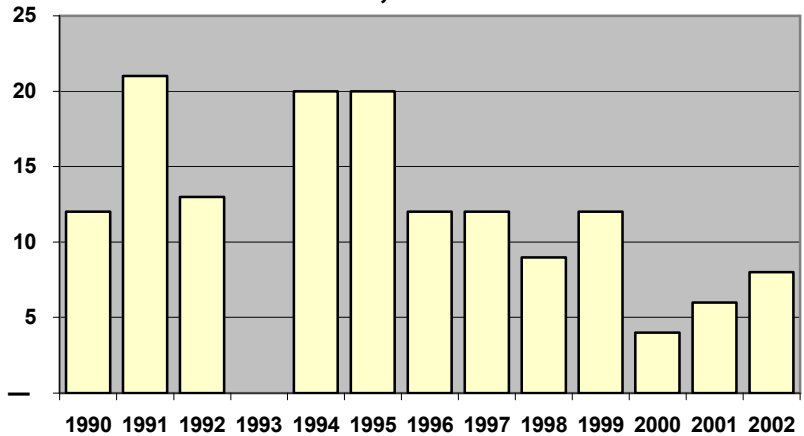
- **Home rule districts** are allowed to levy sales taxes in 0.25 percent increments. When the state took over the duty of collecting these taxes, in September of 1990, 22 districts were levying the tax. Perhaps in response to the new administrative ease of collecting the tax, many localities have adopted these taxes in the past decade. As of January, 2002, more than 100 home rule districts had enacted sales taxes ranging from 0.25 percent to 1.25 percent. The \$389 million in home rule taxes collected in fiscal year 2000

represented a tax hike of \$260 million over the sales taxes that would have been collected if no home rule tax hikes had taken place in the 1990s.

- As a result of 1999 legislation, *non-home rule districts* are allowed to levy sales taxes starting in January of 2002. Nine districts started collecting these sales taxes in 2002, with rates ranging from 0.5 percent to 1 percent.
- Legislation enacted in 1995 allowed counties with populations over 180,000 to enact (subject to a voter referendum) a **public safety sales tax**, in 0.25 percent increments. 1997 legislation allowed counties of any size to enact the tax. In January of 2002, Kendall and Perry Counties became the 16th and 17th counties to levy this tax.
- The state also allows regional sales taxes for counties located in “mass transit districts.” The **Regional Transportation Authority (RTA) tax** is levied in Cook County and the five “collar counties,” with a 0.25 percent rate in the collar counties and a 0.75 percent rate (1 percent on food and drugs) in Cook County. The **Metro-East Mass Transit District (MED) tax** is levied in Madison County at a 0.25 percent rate and in St. Clair County at a 0.75 percent rate.¹⁹ A **County Water Commission Tax** of 0.25 percent is levied in DuPage, Cook and Will Counties.
- The tax base for the home rule, non-home rule, and public safety sales taxes cannot include food, drugs or vehicle sales. The tax base for the RTA and MED taxes does include food and drugs.

As a result of this network of local sales tax rates, the sales tax in most counties exceeds the statewide rate of 6.25 percent. For example, the total sales tax on most transactions in the city of Chicago is 8.75 percent. A recent study by the District of Columbia Department of Revenue²⁰ compared the total sales tax burden in the largest cities of all fifty states and found that Chicago’s sales tax burden ranked second highest in the nation: only

Districts Increasing Home Rule Taxes, 1990-2002



the 9 percent combined sales tax rate in New Orleans exceeded the rate levied in Chicago.

A Narrow Base

If the Illinois sales tax *rate* is high compared to most other states, how can the overall sales tax *burden* be lower than the national average? The answer lies in the definition of the Illinois sales tax *base*.

The Illinois general sales tax actually has two components: the retailers’ occupation tax, which generally taxes sales of tangible personal property, and the service occupation tax, which generally taxes sales of property used in performing nontaxable services. The sales tax base defined by these two taxes is quite narrow compared to that of most other states. One recent analysis found that the Illinois sales tax base in fiscal 1998 was narrower than all but three other states.²¹ The narrowness of the Illinois sales tax base is due to two types of exemptions: exemptions of *tangible property*—the basic building block of all sales taxes historically—and exemptions of *services*, which have never been effectively taxed by most states.

Many states have tried to compensate for the regressivity of general sales taxes by exempting

¹⁹No other district is allowed to levy the MED tax except, Monroe County, which does not currently do so.

²⁰*Tax Rates and Tax Burdens In The District of Columbia, A Nationwide Comparison 1999*. Chief Financial Officer, June 2000.

²¹John Mikesell, “Remote Vendors and American Sales and Use Taxation,” *National Tax Journal* 53/4, p. 1273 (2000). Mikesell estimates the implicit Illinois sales tax base to be about 31.8% of personal income, substantially below the national average of 49.5 percent, and lower than all other states except Rhode Island, New Jersey, and Massachusetts.

High Rate, Low Yield: The Illinois Sales Tax

State	State GST Rate	Regional Rank	State GST Revenue as % of Income	Regional Rank
Illinois	6.25%	2	1.6%	7
Indiana	5%	4	2.2%	5
Iowa	5%	4	2.3%	4
Michigan	6%	3	2.6%	1
Minnesota	6.50%	1	2.4%	2
Missouri	4.225%	7	1.9%	6
Wisconsin	5%	4	2.3%	3

SOURCE: Bureau of the Census, Bureau of Economic Analysis

certain retail sales of tangible property that can be considered essentials. The most popular such exemption is for sales of prescription drugs, which are fully exempted by every state with general sales taxes except Illinois. Another increasingly popular exemption is for groceries. Twenty-seven states now exempt sales of groceries from the state sales tax.²² Six states exempt sales of non-prescription drugs and six states (all in the Northeast) exempt sales of most items of clothing. Illinois takes a relatively unusual approach: instead of completely exempting necessities, the state applies a special lower tax rate to sales of groceries, prescription drugs, and nonprescription drugs. These items are taxed at a 1 percent rate, substantially less than the 6.25 percent general rate.

While these reduced rates lessen the regressivity of the sales tax, they have two important shortcomings:

- **Poor targeting.** Much of the tax relief generated by these reduced rates goes to better-off households for whom the sales tax burden is already relatively low. Less than 9 percent of the tax relief from the state's reduced rate for groceries goes to the poorest twenty percent of Illinois taxpayers. This means that the vast majority of the tax savings from the food exemption go to better-off taxpayers. And the reduced rates also apply to

²²Georgia phased out its food tax between 1996 and 1998; North Carolina phased out its tax between 1997 and 1999; Missouri lowered its food tax from 4.225% to 1.225% in 1997; Virginia recently began a series of rate reductions, beginning in January of 2000, that will lower the state sales tax on food from 3.5% to 1.5% by 2003. South Carolina adopted a temporary cut in its sales tax rate, which has since expired.

residents of any state consuming these items in Illinois—so the tax breaks from the exemption are not limited to Illinois residents.

- **Cost.** Because the benefits from the reduced rates are so poorly targeted, these tax breaks are quite expensive. The reduced rates for food, drugs and medical appliances have been estimated to cost over \$1 billion in fiscal year 2000—almost 16 percent of total state sales tax collections. This means that each penny of the state sales tax yields about 16 percent less revenue than it would in the absence of these exemptions. Some economists have argued, in fact, that states exempting important items such as groceries are likely to respond to the revenue loss by increasing sales tax rates.²³ If states do, in fact, respond to exemptions this way, the goal of providing low-income tax relief may be frustrated.

All state sales taxes also include provisions for exempting sales of tangible property purchased by businesses as inputs into the production process. Despite the widespread use of these provisions, there is evidence that business purchases remain a substantial part of the sales tax base in most states.²⁴ This is because the general approach taken by states has been to exempt only business purchases of tangible property that physically becomes part of a final retail product. But sales taxes on other businesses purchases also end up in the price of retail goods and services, leading to tax pyramiding, that is, multiple taxation of the same final products. Pyramiding results in unfair differences between the tax treatment of otherwise identical products depending on how vertically integrated a business may be. For this reason, economists generally agree that it is theoretically desirable to exempt business purchases used in production—including purchases of business services.

²³Roy Bahl and Richard R. Hawkins, "Does a Food Exemption Lead to a Higher State Sales Tax Rate?" *State Tax Notes*, January 5, 1998, p.29. See also Calvin Kent *et al.*, "The Impact on the Economically Disadvantaged of the Sales Tax on Food: Evidence from West Virginia," *States Tax Notes*, Nov. 9, 1998, p.1201.

²⁴Raymond J. Ring, Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," 42 *National Tax Journal* 167 (1999).

The Illinois exemptions for essentials and business inputs were explicitly written into the tax code by legislators. Yet the most important class of sales tax exemptions allowed in Illinois can't be found on the books at all. While the Illinois sales tax base applies to sales of tangible property unless exempted, sales of intangible services are exempt unless explicitly taxed. This is due to an accident of history: throughout the first half of the twentieth century, economic activity in the United States was focused primarily on the production and consumption of tangible goods, and the production of services was much less important as a share of GNP. However, since 1950, the importance of services has almost continuously increased as a share of the economy, and the goods-producing sectors of the American economy have declined by roughly the same percentage: in the mid-1970s, service-producing sectors first accounted for more than half of private GNP. In 1997, the share of U.S. current-dollar Gross State Product accounted for by private services-producing industries was 63.9 percent.²⁵ Industries such as agriculture, manufacturing, mining, and construction have become less important during the last fifty years, and have been replaced by services, retail and wholesale trade, finance, insurance and transportation. Individual consumption patterns have changed accordingly.

Unfortunately, most state sales taxes were

adopted in the 1930s and 1940s—before this wholesale transformation in consumption patterns had taken place. The challenge facing states like Illinois—which adopted its sales tax in 1933—is to redefine the sales tax base to include at least some sales of personal, professional, or business services. However, many states have failed to achieve this. A 1996 study by the Federation of Tax Administrators (FTA) found that of 164 potentially taxable services, less than half were taxed by most states. The survey found that 16 of the 45 states (plus Washington, D.C.) levying sales taxes in 1996 included less than 30 of these services in their tax base.

Illinois has done less than almost every other state to include this fast-growing area of consumer spending into the sales tax base. The table below shows how midwestern states have (or have not) integrated various personal and other services into their tax base. Of the 164 services listed by FTA, Illinois taxed just 17 in 1996—most of them residential and business utility services.

The unwillingness of policy makers to extend their sales tax to services is troublesome not only from a revenue perspective, but from an equity perspective. The approach Illinois has taken—uniformly exempting sales of services, while taxing most sales of tangible property—discriminates against taxpayers who prefer to consume commodities and in favor of those who consume services.

Sales Taxation of Services: A Midwest Comparison

	Illinois	Iowa	Kentucky	Michigan	Missouri	Wisconsin	U.S. Average	Total # of Services Taxable
Utilities	12	13	10	12	8	11	9	16
Personal	1	15	2	4	1	11	6	20
Business	1	18	4	7	2	6	10	34
Computer	1	—	—	1	1	1	2	6
Admission/Amusements	—	13	6	1	11	13	7	14
Professional	—	—	—	—	—	—	1	8
Fabrication, Repair & Installation	1	14	3	2	—	14	8	19
Other	1	21	1	2	5	13	11	47
Total	17	94	26	29	28	69	53	164

SOURCE: Federation of Tax Administrators

²⁵<http://www.bea.doc.gov/bea/regional/articles/0699rea/maintext.htm>.

There exists broad unanimity among economists that the future vitality of the sales tax depends on its expansion to include services. Yet the same economists stress that any reform which expands the tax base to include services must distinguish between services consumed by *individuals* and services consumed by *businesses*. If the goal of a properly designed sales tax is to tax all (and only) retail sales for final consumption, then the appropriate route to base expansion is not a uniform sales tax on all services, but a uniform tax on all final retail purchases, including all goods and services. Many of the 164 currently untaxed services in the FTA survey are not purchased by residential consumers at all, but are consumed by businesses as an intermediate step in the production process. Taxing the intermediate purchases made by businesses is tempting from a revenue-raising perspective, but is undesirable because it distorts the economic behavior of businesses. A company that finds itself taxed four times in the process of producing a single good (three times on the purchase of intermediate goods and once in the sale of the final product) will face an incentive to escape taxation by vertically integrating and producing intermediate goods itself.

For this reason, the most clear-cut case can be made for extending the sales tax base to personal services such as lodging, admissions, barber and beauty services, and repair services.

The Importance of Remote Sales

The biggest structural concern facing sales tax administrators is the increasing importance of remote sales—retail transactions in which the seller has no physical presence in the state. A pair of U.S. Supreme Court decisions²⁶ have created a potentially dangerous loophole for retail merchants operating from outside state lines: Illinois cannot require an out-of-state merchant to collect sales taxes on purchases made by Illinois residents, unless the merchant has a physical presence in Illinois. One reason the Court has refused to force out-of-state merchants to collect sales taxes is the alleged complexity of the various state and local sales tax structures—with so many states, counties and municipalities levying different taxes at different rates with different tax bases, the Court says, it's

²⁶*National Bellas Hess v. Illinois* (1967) and *Quill v. North Dakota* (1992).

Sales Tax Holidays: A Good Deal?

An increasingly popular approach to sales tax reductions is the temporary “sales tax holiday.” Since New York introduced the practice in 1997, a total of eight states have enacted short-term sales tax exemptions for particular items. Sales tax holidays are generally designed (and marketed) as a means of providing “back to school” sales tax relief, for a period ranging from two days to two weeks, and usually take place during the month of August. These exemptions generally apply only to sales of clothing and/or footwear, although Pennsylvania’s recent sales tax holiday applied only to sales of computers.

Two principal objections can be made to the sales tax holiday approach. First, the short-term tax cuts realized by consumers from these cuts pale in comparison to the overall sales tax burden falling on a state’s taxpayers. The imposition of brief sales tax holidays on particular retail sales may serve to minimize public awareness of the overall inequity of sales taxes. Second, it is not immediately clear how much (if any) of the sales tax cuts due to these holidays will be passed on to consumers, and how much will be retained by retailers.

too cumbersome a task for these retailers to figure out the appropriate tax to collect. For this reason, states have begun to collaborate to simplify state sales tax structures: the idea is that if states simplify the tax bases and tax rates, the Court might allow states to tax remote sales.

Why should Internet transactions be taxed?

The most appealing solution to the question of the appropriate tax treatment of e-commerce is that it should be treated in exactly the same manner as other retail transactions. That is, retail transactions that are taxable when sold as a “bricks and mortar” transaction should also be taxable when sold via electronic transactions. There are several reasons for taking this approach:

- In general, sales tax exemptions create substantial tax complexity. Sales tax exemptions for groceries require detailed regulations to enforce and define simply because “groceries” are a concept that requires explicit definition. It seems likely that a sales tax exemption for “electronic” transactions would require fairly precise—and contestable—definition as well.

- Exempting e-commerce transactions violates basic tax policy principles of horizontal equity. Retailers who choose (or are forced) to sell their wares primarily in a bricks and mortar setting are unfairly disadvantaged by a policy that exempts e-commerce. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their bricks and mortar purchases. To the extent that Internet access is less available to lower-income taxpayers, exempting Internet purchases from tax probably increases the regressivity of sales taxes, as wealthier taxpayers are able to avoid sales taxes by buying on-line.
- E-commerce exemptions also violate the principle of economic neutrality. By providing tax incentives for retailers to conduct transactions electronically, such exemptions would distort the overall pattern of economic transactions.

currently allow such a credit.²⁷ This approach offers several advantages over sales tax exemptions: low-income credits can be targeted to state residents only, and can be designed to apply to whichever income groups are deemed worthy of tax relief. The box below shows the details of one such program, the Kansas food sales tax refund. Kansas lawmakers have targeted this rebate to taxpayers over 55 and taxpayers with children under 18. Eligible taxpayers must also earn less than \$25,000 a year.

The Kansas Food Sales Tax Refund	
Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.	
Income Level	Refund
\$0 to \$12,500	\$60 per exemption
\$12,501 to \$25,000	\$30 per exemption
\$25,001 or more	no refund

Options for Progressive Tax Relief

This chapter has identified two types of exemptions which limit the yield of the Illinois sales tax and exert upward pressure on the tax rate: the preferential rate for food and drugs, and the almost uniform exemption of services from the tax base. Each of these can be addressed in ways to increase the productivity and equity of the tax without adding to the tax burden on low-income Illinoisans.

Sales Tax Credits

Illinois lawmakers have enacted major sales tax exemptions with the goal of reducing the tax burden on low-income taxpayers. Yet even in cases where the exemptions reduce the overall regressivity of the sales tax (for example, the reduced rates for groceries and medicine), the real impact of the exemptions may be to exert upward pressure on the rate that applies to all other taxable items. This is an unavoidable consequence of sales tax exemptions: these exemptions are granted to everyone purchasing the exempt item, from the poorest worker to the wealthiest Illinoisan to the out-of-state visitor buying groceries.

A less expensive—and better-targeted—approach to low-income sales tax relief is a low-income credit for sales taxes paid. Five states

The current reduced sales tax rates for food and drugs apply to all purchasers of the preferred items, regardless of income level or state of residency. On the other hand, because these credits are generally administered through the state income tax, low-income taxpayers must file a tax form to claim them: taxpayers who aren't aware of such a credit will not claim it. For this reason, any such credit should be publicized sufficiently that low-income taxpayers will be aware of its availability.

Taxing Services

Lawmakers in many states have recognized the beneficial effects of taxing services on the overall equity of the sales tax and on the yield of the tax. Both are important concerns: the tax system should not punish Illinoisans who are more likely to consume goods than services, and the perceived equity of the tax system suffers when otherwise identical taxpayers are treated differently in this way. There is no sound rationale for taxing the personal consumption expenditures of the predominantly lower-income Illinoisans who focus their spending on tangible goods, while exempting the consumption expenditures of higher-income Illinoisans who are more likely to purchase exempt services.

²⁷These states are Idaho, Kansas, Oklahoma, South Dakota, and Wyoming.

While the potential revenue yield of taxing services is immense, this sort of base expansion can also be used in a way that leaves net tax collections unchanged. For example, lawmakers in Minnesota have recently considered proposals which would broadly tax services and use the additional revenue to reduce the state sales tax rate across the board.

Excise Taxes

Excise taxes in Illinois are more important as a revenue source than in most other states—and the aggregate burden from these taxes is above-average as well.

The Illinois *cigarette excise tax* was introduced in 1941, at a rate of 2 cents per pack. The rate remained below 10 cents per pack until 1969. Since 1985, however, legislators have enacted a series of substantial cigarette tax hikes, increasing the rate

Illinois Cigarette Tax Rate Hikes

Year	New Rate Per Pack
1969	12 cents
1985	20 cents
1989	30 cents
1993	44 cents
1997	58 cents

on four separate occasions in the past 15 years. As a result, the tax rate on cigarette sales has more than quadrupled since 1985, representing a 46-cent-per-pack tax increase over that period. And the tax rate has almost doubled since 1993.²⁸ In 2000, the Illinois cigarette tax was third highest among neighboring states—substantially less than the rates in Michigan and Wisconsin, but significantly more than the rates in Indiana and Missouri—and fifteenth in the nation. In 1993, the state introduced a new *tobacco products tax* on tobacco other than cigarettes.

Illinois levies a separate tax on *telecommunications services*, which raised almost \$800 million for the state in fiscal year 2000. As with other taxes based on consumption, the burden of this tax falls

²⁸Almost half of the revenues from these hikes (22 cents' worth) are deposited directly into the state's Common School Fund to pay for the costs of K-12 education, including all of the 14-cent tax increase enacted in the 1997 special legislative session.

disproportionately on the poorest Illinoisans. The rate is currently set at 7 percent of phone charges, as a result of a 2 percent hike in 1997.

The Illinois *motor fuel excise tax* has also been expanded significantly in recent decades. Introduced as a 3 cent-per-gallon tax in 1929, the tax was still just 7.5 cents in 1982. But after a series of hikes during the 1980s, the tax rate almost tripled by 1990, when it was set at the current 19 cents per gallon.

Cigarette and Gas Taxes in 2000

	Cigarettes (Per Pack)	Gasoline (Per Gallon)
Illinois	58¢	19.0¢
Indiana	15.5¢	15.0¢
Iowa	36¢	20.0¢
Michigan	75¢	19.0¢
Minnesota	48¢	20.0¢
Missouri	17¢	17.0¢
Wisconsin	77¢	27.3¢

Illinois is relatively unusual in that it also applies the statewide 6.25 percent sales tax to gasoline. Illinois is one of only nine states that double taxes gasoline in this manner. Illinois also applies additional storage fees and taxes amounting to 1.1 cents per gallon, designated for state environmental spending.

This multiple-taxation approach to the gas tax is a mixed blessing: because the sales tax on gasoline is an *ad valorem* tax, calculated as a percentage of the sales price, this tax is not subject to the inflationary losses that characterize the gasoline excise tax. Yet the overall regressivity of the gas tax means that revenue growth is derived disproportionately from those least able to afford it.

Illinois levies several excise taxes on sales of *alcoholic beverages*, including beer, wine and distilled liquor. As part of the 1999 "Illinois FIRST" tax increases, each of these taxes were substantially increased. The chart above shows the excise tax rates before and after the 1999 changes. The beer

Liquor Tax Increases in Fiscal 2000

	Fiscal Year		% Change
	1999	2000	
Beer	7¢	18.5¢	164%
Alcohol:			
<14%	23¢	73¢	217%
14-20%	60¢	73¢	22%
>20%	\$2.00	\$4.50	125%

tax was almost tripled, from 7 cents per gallon to 18.5 cents per gallon. The tax on wine was more than tripled, from 23 to 73 cents per gallon. As a result, the burden of liquor taxes on Illinoisans in fiscal 2000 was *double* the tax burden in the previous year. The tax hikes from these changes fall disproportionately on low-income Illinoisans.

Excise Taxes and Inflation

Most retail sales taxes are levied on an *ad valorem* basis—that is, they are calculated as a percentage of the price. This means that inflationary changes in the cost of taxable items are carried through to the *ad valorem* tax, and the yield of the tax increases with inflation. Unlike sales taxes, excise taxes are generally imposed on a *per-unit* basis rather than as a percentage of the sales price: for example, the Illinois cigarette tax is a flat 58 cents per pack, no matter how much the pack of cigarettes costs. The per unit nature of excise taxes means that these taxes inherently grow more slowly than the economy. The yield of a gasoline tax that is levied at 20 cents per gallon will not change when the price of gasoline changes. Excise tax revenue grows (or contracts) only when the volume of the commodity sold grows or contracts, and does not respond to changes in prices. In an inflationary environment, this means that states must continually raise the

rates of excise taxes in order to keep revenues up with inflation. The chart below shows the effect of inflation and legislated changes on the real value (in 2000 dollars) of the state's excise tax on gasoline. The gasoline tax rate has been infrequently increased since the introduction of the tax in 1923. The pattern is that the inflation-adjusted rate increases after a nominal tax hike, and then gradually falls back below its original position. Even with the numerous recent changes in the nominal tax rate, the inflation-adjusted rate is currently less than two thirds of its original value.

Conclusion

Consumption taxes are the most regressive major tax levied by states. Illinois consumption tax revenues have grown more slowly than in most states during the past two decades—yet the state has one of the highest statutory sales tax rates of any state. This apparent contradiction is due to the narrowness of the state sales tax base. Illinois allows exemptions designed to reduce the regressivity of the tax—such as the reduced rates for food, utilities and drugs—and exemptions which are accidents of history, such as the almost complete exemption of personal and professional services from the tax. Any substantial reform of the Illinois sales tax should address these gaps in the sales tax base.

Effect of Inflation on Excise Taxes: Illinois' Gasoline Excise Tax in Nominal and Inflation-Adjusted 2000 Dollars

