Update: Public utility taxation in Illinois

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In the summer of 1985, the Illinois legislature passed a bill that will partially convert the state public utility tax from a gross receipts to a usage basis beginning in January 1986. The new law was passed in response to increasing public opposition to the current state utility tax. Many critics charged that the tax was too high and too regressive. There was also concern over the large automatic increases in tax revenues which necessarily accompanied the rising utility prices of the 1970s and 1980s.

The current state utility tax is levied at a five percent rate on gross receipts from the sale of gas, electricity, and message services. Under the new law, gas sales may be taxed at 2.4 cents per therm and electricity sales may be taxed at 0.32 cents per kilowatt hour. Utility customers whose tax bill would be higher under these usage rates will be allowed to continue paying the five percent gross receipts tax.[1] The new law will not alter the current gross receipts taxation of message services.[2]

Changes in utility taxation are also being considered in the City of Chicago. At the time of this writing, the mayor's 1986 budget plan included a proposal that the city's eight percent utility tax be converted to a usage basis.

In a recent issue of *Economic Perspectives*, we discussed the severity, equity, stability, and administrative features of the current state and local utility taxes in Illinois.[3] We found that these taxes are very high in Illinois compared to utility taxes in other states. They are also very regressive and may discourage growth of utility-intensive industries in the state. On the other hand, utility taxes have low administration and compliance costs, and they tend to be as stable over the business cycle as other major state taxes.

In this update we consider the likely effects of the new state utility tax. We find that the new tax will be lower and less sensitive to utility prices. The tax distribution will change because customers who face the highest utility prices will benefit most from conversion to the usage rates. The overall tax burden will be less regressive, and the residential share of the tax will be distributed more equally among households with similar income levels. However, some state residents could lose a federal tax offset if the IRS rules that the utility tax is not deductible from the federal income tax.

Effect on state revenues

The clearest consequence of the new utility tax law is that state utility tax revenues will decline. Many taxpayers will have a direct reduction in their utility tax, while others will pay the same tax as they would otherwise under the five percent gross receipts rate. As a result, the total revenues to the state must go down. The Bureau of the Budget has estimated that utility tax revenues will decline $23 million in the first six months of 1986 and $80 million in fiscal year 1987. Using the latest utility sales information available we estimate that if the usage tax had been in effect in calendar year 1984 the state's utility tax revenues would have been $70 million lower.

The tax revenues will also be less sensitive to utility prices since the usage tax will be determined by utility consumption instead of prices. If utility prices increase in the future, more taxpayers will switch from the gross receipts rate to the usage rate. As a result, the tax will become progressively less sensitive to utility prices over time.

Despite the decline in state utility tax revenues, the level of utility taxation in Illinois will still be high relative to that of other states. Our earlier article demonstrated that Illinois currently has one of the highest levels of utility taxation in the country. It compared the sum of revenues collected in each state from taxation of utility sales under sales and selective excise taxes at the state and local levels.

We found that in 1982 Illinois' state and local utility taxes were among the top ten in the country according to four measures of tax level and importance. Two of these rankings are

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shown in Table 1. The burden of utility taxation on state residents is indicated by utility tax revenues per capita. Illinois ranks third in the nation according to this measure. The second ranking compares the extent to which utility consumption is tapped as a tax source in each state. The sum of gas, electricity, and telephone service sales is used to estimate the potential utility tax base in each state. Actual utility tax revenues divided by this standard tax base provide a measure of utility tax level that is not affected by variation in utility consumption due to differences in state size, industry mix or proximity to energy sources. Illinois ranks eighth in the country with an effective utility tax rate of 7.6 percent.

The new state utility tax will lower Illinois' position in these rankings but not enough to cause the state to fall out of the top ten. As stated earlier, the new law would have caused a $70 million tax reduction if it had been imposed in 1984. To estimate the impact of the new law on the two rankings, we convert this reduction into 1982 dollars and remove it from the two measures. With this adjustment, Illinois falls from third to fourth in the ranking of per capita tax revenue and from eighth to ninth in the ranking of the effective tax rate (see Table 1). Thus, although the new law will lower Illinois' state utility tax, the state's total utility taxation level will still be one of the highest in the country.

However, Illinois' ranking could fall further if utility prices were to increase dramatically across the county. Utility taxes are levied on gross receipts in most states. Thus, rising utility prices would increase utility tax revenues more in other states than in Illinois.

Changes in tax distribution among customer groups

The new state utility tax will not affect all utility customers equally because utility prices vary widely for different types of users. Residential customers will benefit the most because their utility taxes are currently based on gas and electricity prices which generally exceed the prices charged to commercial and industrial users. Table 2 shows the total utility tax reduction for each customer class if the new law had been in effect in 1984. Residential electricity users would have saved 28 percent on their utility tax, while commercial custom-

Table 1
Ten states with highest state and local public utility tax revenues–fiscal 1982

Revenues per capita		Revenues as a percent of standard base	
New York	$103.79	New York	12.7%
New Jersey	89.51	New Jersey	9.2
Illinois	77.77	Hawaii	8.3
Hawaii	75.85	West Virginia	8.2
Florida	69.76	Florida	8.2
Connecticut	69.51	Washington	8.2
West Virginia	65.71	Connecticut	8.1
Arizona	61.77	Illinois	7.6
Rhode Island	56.46	Rhode Island	7.5
Pennsylvania	55.53	Missouri	6.9
Rankings adjusted for new Illinois state utility tax			
New York	$103.79	New York	12.7%
New Jersey	89.51	New Jersey	9.2
Hawaii	75.85	Hawaii	8.3
Illinois	72.22	West Virginia	8.2
Florida	69.76	Florida	8.2
Connecticut	69.51	Washington	8.2
West Virginia	65.71	Connecticut	8.1
Arizona	61.77	Rhode Island	7.5
Rhode Island	56.46	Illinois	7.1
Pennsylvania	55.53	Missouri	6.9

ers would have saved 18 percent. Industrial electricity prices were low enough that most industrial customers would still have been taxed under the gross receipts rate.

Residential gas customers will also have a large tax savings under the new law. In 1984, those without space heating would have had a 32 percent tax reduction and those with space heating would have had a ten percent reduction. Commercial and industrial customers, on the other hand, would have experienced very small decreases in state utility tax.

Although the residential sector will benefit from a large decline in utility tax payments under the new law, there is little reason to expect the regressive distribution of the residential tax to change. Residential customers of each utility face the same utility prices, so the utility tax will fall by the same percentage for households of all income levels. Thus, the tax will continue to constitute a much higher income share for lower income people.

However, the utility tax as a whole is likely to become less regressive as the residential share of the tax declines relative to the share levied on commercial and industrial utility customers. The residential taxes are highly regressive because they are levied on consumption of vital services which make up a larger share of income for low-income households than for middle and upper income families. The commercial and industrial utility taxes, on the other hand, are probably borne to a greater extent by middle and upper income households. These taxes are most likely passed on either to the customers or to the stockholders of the commercial and industrial utility taxpayers. Most goods in the economy have a higher income elasticity than utility services, and most stockholders have relatively high incomes. Therefore, as the commercial and industrial share of the state utility tax increases relative to the residential share, the total utility tax will become less regressive.

Changes in tax distribution across the state

The new law will also equalize the tax paid by residential customers with similar income levels. Residential utility prices vary greatly from one utility to another, so that state utility taxes differ across the state for people with the same income level. Most residential customers will convert to the usage tax rate under the new law. Since households with similar incomes tend to have similar levels of utility consumption, the new utility tax will be fairly equal for people with the same income level. Moreover, geographical disparities in total utility costs will be reduced somewhat when utility taxes become more even across the state.

The new state law achieves this tax equalization by lowering the utility tax more for customers of some utilities than others. The state maps in Figures 1 and 2 illustrate which electric and gas utilities would have experienced the greatest decline in the residential utility tax if the new law had been imposed in 1984. Figure 1 shows that Commonwealth Edison customers would have benefited most from the new tax with a 33 percent utility tax reduction. Central Illinois Light and Central Illinois Public Service customers would have had substantial tax reductions of 25 and 20 percent, respectively. The only utilities whose residential prices were too low for their customers to benefit from the usage tax were Union Electric and South Beloit Water, Gas & Electric.

Table 2 shows that the utility tax reduction for residential gas customers would

Table 2
1984 reduction in state utility tax under new law by customer class

Electricity sales	
Residential	28%
Commercial	18
Industrial	*
Total	17
Natural gas sales	
Residential without space heating	32
Residential with space heating	10
Commercial and industrial without space heating	2
Commercial and industrial with space heating	5
Commercial and industrial interruptible sales	1
Total	8
Total tax reduction	13

*Less than one percent reduction.
SOURCE: Estimates based on 1984 electricity and gas sales data from the Illinois Commerce Commission.

Figure 1
Reduction in state utility tax under new law for residential electricity users

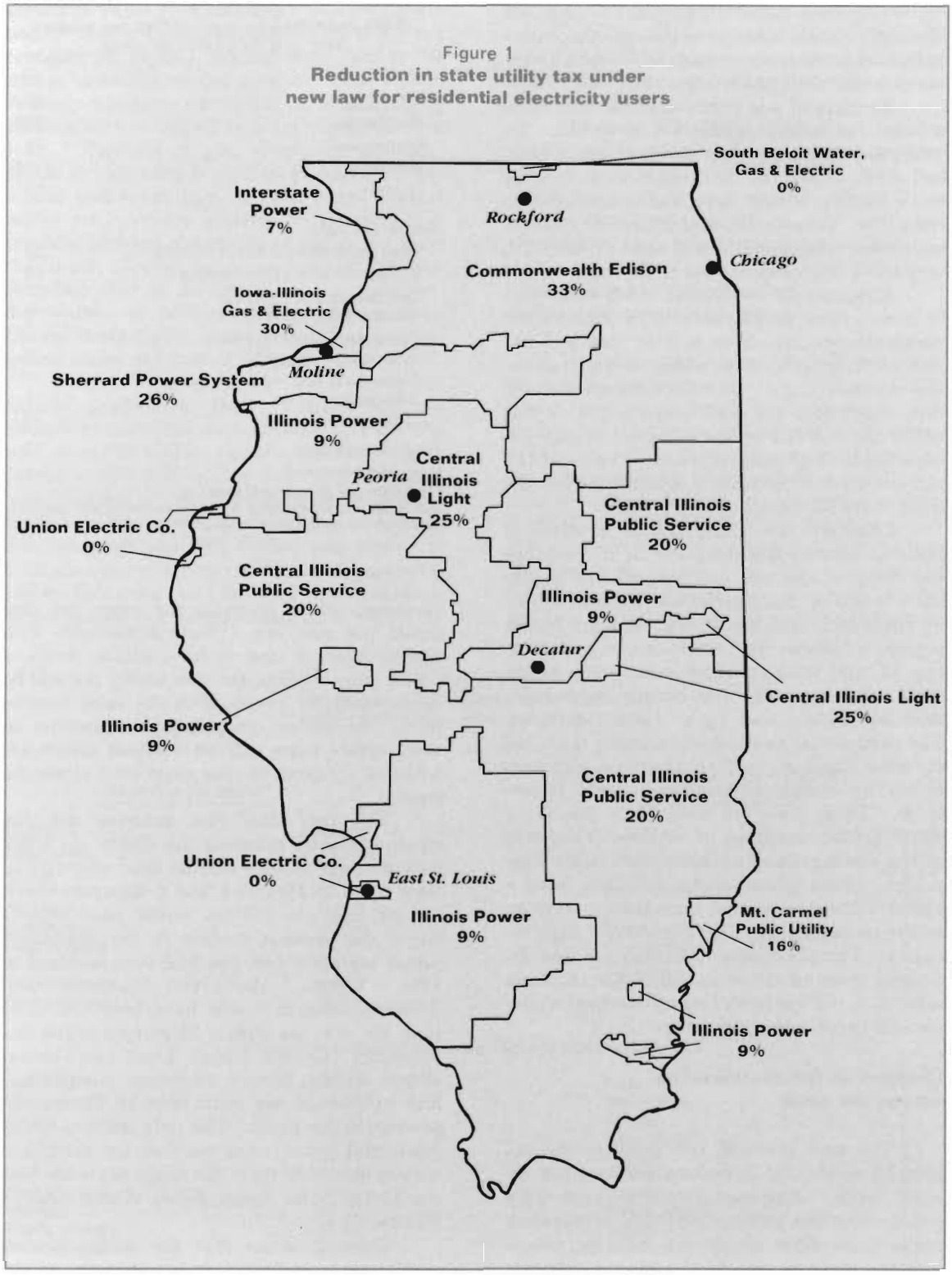
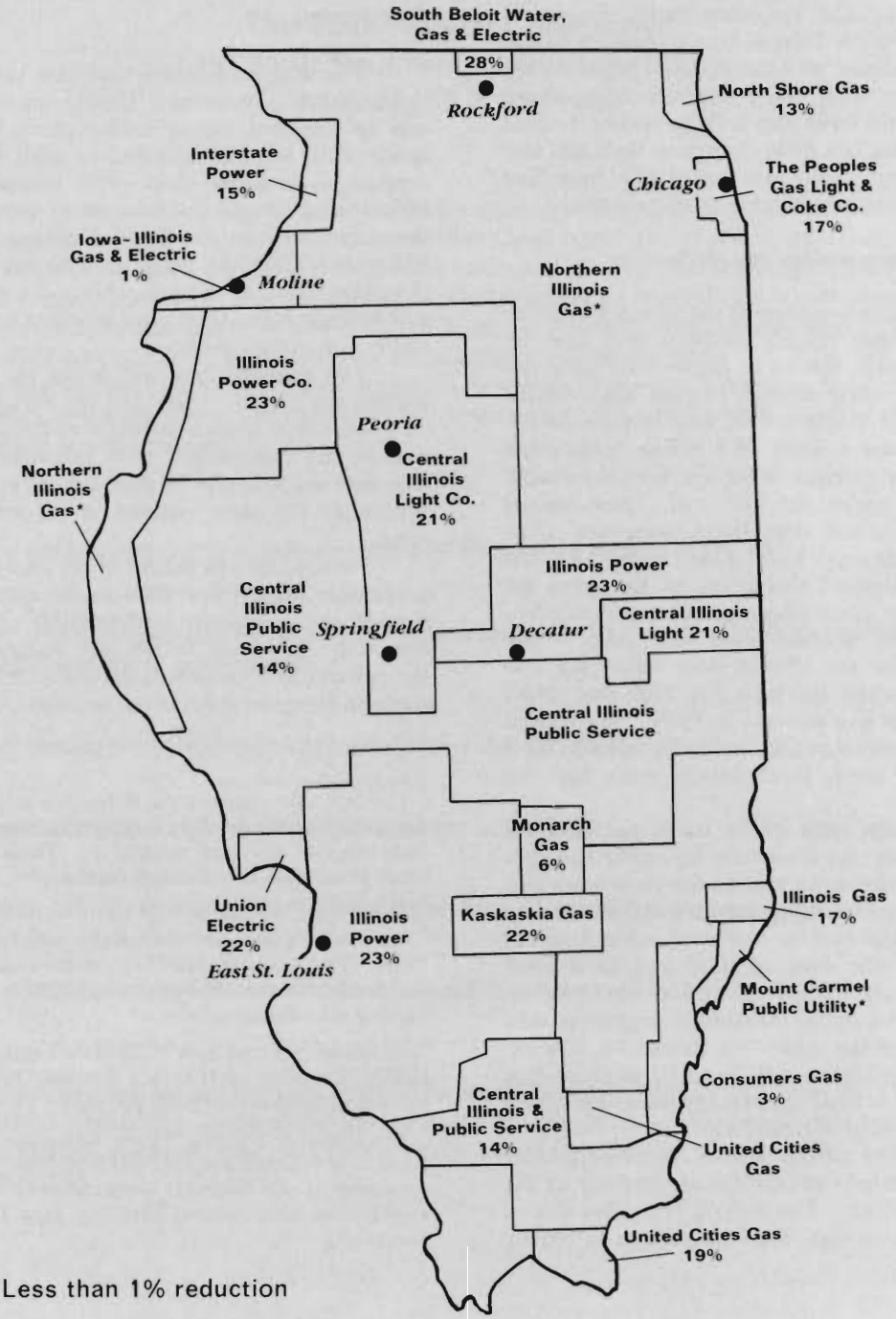


Figure 2
Reduction in state utility tax under new law for residential gas users



have ranged from less than one percent to 28 percent in 1984. Peoples Gas customers would have had a 17 percent tax decrease. Thus, Chicago residents would have experienced a large decline in both their electric and gas utility taxes. On the other hand, the neighboring Northern Illinois Gas customers would have had almost no change in their gas utility taxes. Therefore, many residents in northern Illinois would have had a large saving in their electricity tax but little change in their gas tax. Illinois Power customers would also have had a substantial tax reduction of 23 percent.

Loss of state utility tax deduction

One disadvantage of the new state utility tax law is that Illinois residents may lose the right to claim the state utility tax as a deduction on their federal income tax returns. Illinois' state utility tax became eligible for deduction under a 1984 IRS ruling. Although utility gross receipts taxes are not universally deductible under the IRS code, past rulings have maintained that these taxes are often similar to general sales taxes. The IRS has generally allowed deduction of the gross receipts tax in cases where its tax rate was identical to the general sales tax rate. The deduction for the Illinois state utility tax was permitted when the sales tax rate was raised from four to five percent in 1984. Since local sales tax rates in Illinois rarely match local utility tax rates, local utility taxes are not deductible.

The new state utility tax is not likely to be deductible, for it will not be applied to utility sales at the same rate as the state sales tax. The cost to Illinois residents from the loss of this deduction can be estimated using a recent measure of the share of state and local taxes exported from Illinois through federal tax deductions.[4] Assuming all eligible taxpayers take advantage of the utility tax deduction, it is estimated that Illinois will lose $10 to 15 million per year in federal tax savings from the switch to the usage-based utility tax.

The loss of the federal income tax deduction will help reduce the regressivity of the state utility tax. The federal tax offset allows people who itemize their tax returns to reduce their utility taxes. Since lower income households are not as likely to itemize, the new utility tax will fall more heavily on upper and middle income taxpayers.

Conclusion

The new state utility tax law will lower the utility tax revenues. Utility tax revenues will be less sensitive to utility prices because much of the tax will be levied on units of utility consumption rather than gross receipts from utility sales. If gas and electricity prices continue to climb in the future, more taxpayers will switch from the gross receipts tax rate to the usage rate. As a result, utility tax revenues will become increasingly less sensitive to energy utility prices over time.

The new tax law will lower the overall regressivity of the utility tax by reducing the very regressive residential share of the tax relative to the commercial and industrial share. The new tax will also be borne more evenly by people at the same income levels across the state.

Finally, Illinois residents are likely to lose a valuable federal tax offset as the state utility tax will not necessarily be deductible under the new law. This will reduce the regressivity of the tax but at a considerable cost to state residents in foregone federal tax savings.

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[1] The law also changes the definition of gross receipts to exclude services supplied in conjunction with sales of gas and electricity. These include small items such as minimum service and returned check charges.

[2] Another new law did change the message tax in 1985. The tax was extended to cover interstate telephone calls as of August 1, 1985 to provide funding for education reforms.

[3] See Diane F. Siegel and William A. Testa, "Public Utility Taxation in Illinois," *Economic Perspectives*, vol. IX (July/August 1985), pp. 1-16.

[4] See Donald Phares, "Tax Exporting in the American Federal System: 1970 to 1980" (paper presented at the National Association of Tax Administrators 53rd Annual Meeting, June 10, 1985; processed).