

Sales Taxation of Services: Options and Issues

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NC not alone in taxing few services: A product of history

- 24 of 45 states enacted sales taxes 1930-40 to offset plunging property taxes in Depression
 - Most states didn't include services because
 - Services much smaller share of economy
 - Priority was getting enforceable tax up & generating \$\$ ASAP (goods more traceable)
 - Tax on services viewed as tax on labor/jobs
 - Two sales taxes enacted at that time did include generalized taxation of services – HI & NM
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Why should states expand their taxation of services?

- **To improve “horizontal equity” – equal tax treatment of similarly-situated people**
 - Sales tax supposed to be general tax on consumption, tax equally people who consume same \$ amount; failure to tax services unfair to those who prefer goods over services
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Why should states expand their taxation of services?

- **To improve “horizontal equity”**
 - Goods and services often substitutes (e.g., in some states, person who rents DVDs pays sales tax, while person who spends same amount on HBO pays no tax)
 - Eliminate inequities caused by partial taxation of services (e.g., in some states HBO not taxed while pay-per-view is)
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Why should states expand their taxation of services?

- **To raise additional revenue**
 - Substantial untapped revenue potential
 - Fairer to get it from someone avoiding tax on her consumption than to tax existing taxpayer more heavily
 - Preferable to rate increases, which tend to stimulate tax avoidance (e.g., more cross-border and Internet shopping)
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Revenue potential of expanded taxation of household services (NC)

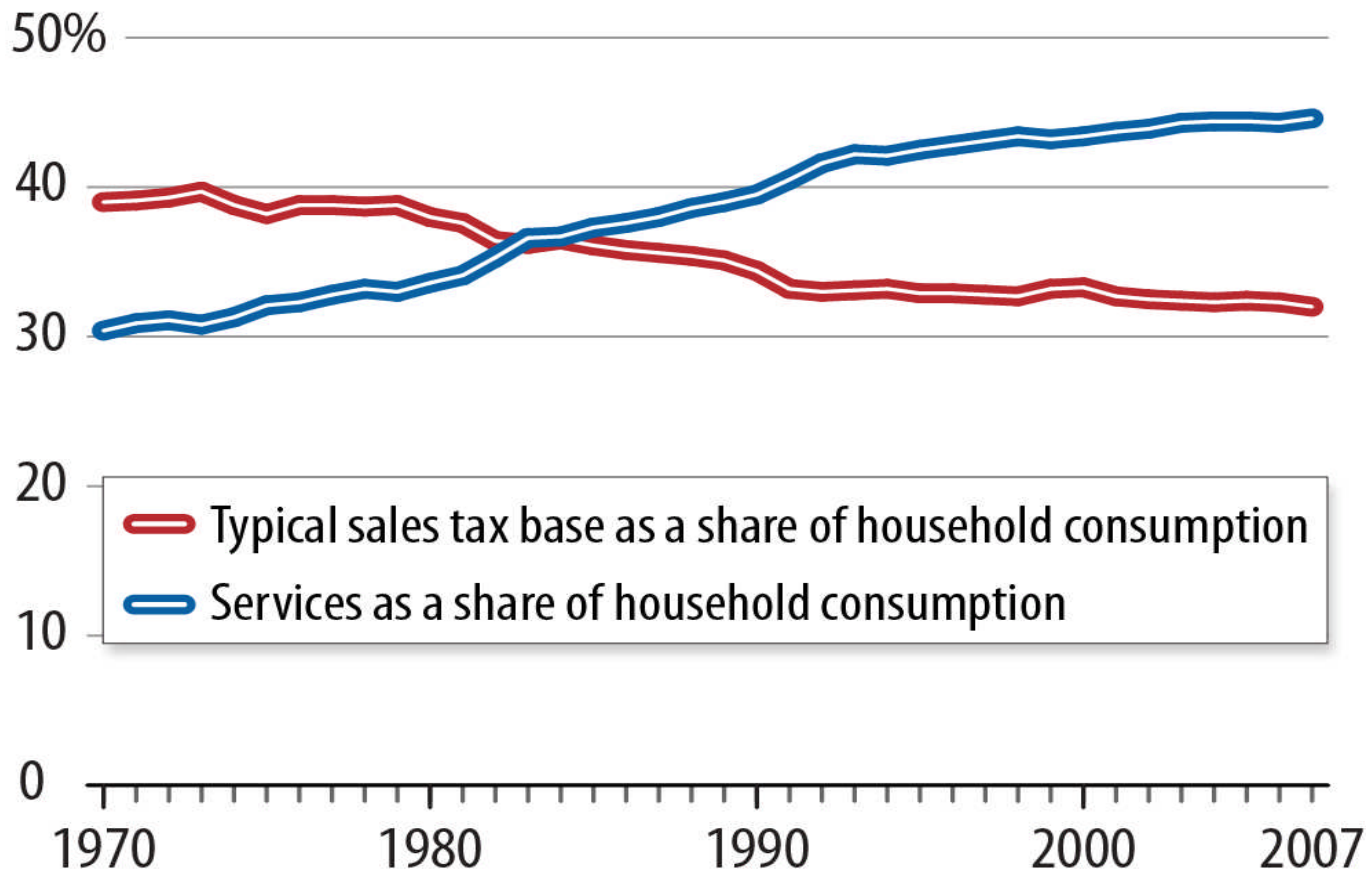
FY10-11 (estimates done for Senate budget plan)

- Installation/repair of tangible personal property: \$253 million
 - Convert existing amusement tax to sales tax: \$28 million
 - Other recreation/entertainment: \$106 million
 - Building repair/alteration: \$75 million
 - Storage and moving: \$20 million
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Why should states expand their taxation of services?

- **To mitigate long-term erosion of sales tax**
 - Economy is shifting from consumption of goods to consumption of services
 - Result: failure of sales tax revenue to grow as rapidly as cost of services sales tax is supposed to pay for
 - This is probably the most important reason to expand sales tax to include more services
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Services are growing as share of consumption



Why should states expand their taxation of services?

- **To reduce sales tax revenue volatility**
 - Greater taxation of services appears to mitigate fall-off in sales tax revenue during recessions
 - People often postpone purchases of big-ticket items when they fear/experience job loss, but they still get their hair cut and cars repaired
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Why should states expand their taxation of services?

- **To eliminate some thorny administrative problems**
 - E.g.: No need to require business to separately report taxable parts and tax-exempt labor if labor is also taxable
 - Can reduce compliance costs for business and enforcement costs for states
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Why should states expand their taxation of services?

- **To improve economic efficiency**
 - Unnecessarily-high sales tax rate from too narrow base creates some adverse economic incentives
 - E.g., artificially stimulates Internet and cross-border shopping
 - E.g., compounds adverse effects of sales taxation of business inputs
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Sales taxation of services and regressivity (1)

- What little research there is suggests that conventional wisdom — that broad taxation of services reduces regressivity of sales tax — is wrong
 - Why: low-income people have to get their cars and plumbing fixed just like more affluent do
 - Extension of sales tax to services purchased mostly by affluent can reduce sales tax regressivity (but little revenue yield)
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Sales taxation of services and regressivity (2)

- Broad expansion to services coupled with completely offsetting rate cut will neither increase nor decrease regressivity of sales tax significantly
 - But generating net additional revenue from sales tax will increase regressivity of overall tax system because of greater reliance on an inherently regressive tax
 - Any net increase in sales tax revenue from expansion to services should be offset with some low-income relief, e.g., expanded EITC
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What are some possible drawbacks of expanding the sales tax to services?

- **Brings many new retailers into system**
 - Have to be registered, educated, have returns processed, be audited
 - In contrast, rate increase on existing tax base has almost no additional costs
 - Problem sometimes exaggerated; many service sellers also sell taxable goods or self-remit use tax on things they buy
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What are some possible drawbacks of expanding the sales tax to services?

- **Likely substantial noncompliance by individual sellers of some services**
 - Some services often provided “off-the-books” by individuals (e.g., child care, house cleaning, home repair)
 - Income tax reporting already poor; unlikely to collect sales tax
 - Legitimate businesses could be disadvantaged
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Benefits of taxing services outweigh the drawbacks

- Sales tax will fall farther and farther behind growing cost of providing public services if services aren't taxed
 - Potential to raise sales tax rates much further is constrained by Internet sales
 - Need for horizontal equity; people shouldn't have different sales tax burdens because of how they like to spend their money
 - Significant short-term revenue-raising potential
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What services could states tax?

- Services sold mostly from one business to another (b2b)
 - E.g., payroll processing
 - Services sold mostly to households
 - E.g., personal trainers
 - Services frequently sold to both
 - E.g., auto repair
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States should generally avoid taxing B2B sales of services

- Violates principle of what sales tax is supposed to be – tax on consumption
 - Often leads to “pyramiding” – with possible negative economic, political, and distributional effects
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- Definition: imposing sales tax on inputs into production, passing cost of those inputs into cost of final product, then subjecting full price of product to sales tax all over again
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The case against pyramiding and taxing business inputs (1)

- **Lack of transparency**
 - Citizens don't see what they're paying for public services because part of sales tax is buried in price of what they buy
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The case against pyramiding and taxing business inputs (2)

- **Adverse distributional impacts**
 - Governments rely on regressive sales tax more than they otherwise might because part of sales tax burden buried in prices
 - Some evidence that hidden portion of sales tax is more regressive than visible portion that appears at cash register
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The case against pyramiding and taxing business inputs (3)

- **Possible adverse economic development impacts**
 - Possible disadvantage in competing for customers with out-of-state companies not subject to input taxes
 - If substantial taxation of inputs, can be disincentive to be located in state
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The case against pyramiding and taxing business inputs (4)

- **Adverse effects on economic efficiency**

- Taxation of b2b sales creates incentive for “vertical integration,” i.e. bringing service in-house (e.g. hire accountant employee rather than accounting firm)
 - Tax-induced vertical integration hurts economic efficiency (existence of independent service providers suggests they are more efficient than employees)
 - Competitive disadvantage for small businesses (can’t afford to avoid tax by hiring their own janitors, accountants, etc.) Also, small service businesses lose large corporate customers.
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What are the arguments in favor of taxing b2b sales of services? (1)

- **May be less economically distorting than higher sales tax rate.**
 - There's already substantial taxation of b2b sales of goods; if alternative is sales tax rate increase, may be less economically distorting to put new tax on b2b sales of services than to tax b2b sales of goods at even higher rate
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What are the arguments in favor of taxing b2b sales of services? (2)

- **Can be a “second best,” pyramiding-free approach to taxing household purchases of exempt services and goods**
 - Example: may be distributionally undesirable to tax sale of hospital services, but may be acceptable to tax hospital’s purchases of accounting, electricity, etc. even if passed into price of hospital services
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What are the arguments in favor of taxing b2b sales of services? (3)

- **Some business purchases of services are really disguised form of providing compensation to employees/customers in form of consumption**
 - Company country club memberships
 - Skybox rentals
 - Luxury hotels on business trips
 - “Company” cars
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What are the arguments in favor of taxing b2b sales of services? (4)

- **Reducing sales tax evasion**

- Given large and growing number of self-employed workers, significant potential to claim personal consumption of some services as business-related to evade tax (e.g., telephone, car repair, hotels)
 - Would place unreasonable burden on seller/government to police eligibility for b2b exemption.
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A practical, real-world approach to taxation of b2b services

- States generally should avoid expanded sales taxation of services that are exclusively or primarily sold from one business to another.
 - Should focus efforts on expanding sales taxation of household services
 - Taxation of services widely purchased by both households and businesses (e.g. car repair) is acceptable
 - States should tax business purchases that are disguised forms of personal consumption
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What household services could states tax? (see author's paper for detailed list)

Lawn and garden	Pet-related
Personal transportation	Storage and moving
Residential utility	Telecommunications
Financial and insurance	Personal care
Misc. personal (childcare)	Home cleaning/maintenance
Clothing-related	Education-related
Other professional (legal)	Admissions/recreation/travel
Personal property rentals	Medical
Vehicle repair/maintenance	Residence construction/repair
Housing and real-estate	Misc. repair/installation

What services does North Carolina tax now?

Custom fabrication/printing

Dry cleaning and laundry service

Electricity (reduced rate)

Landline and cellular telephone service

Cable and satellite TV (including pay-per-view) and radio

Commercial art/graphic design

Photocopying

Photo finishing

Some entertainment admissions (reduced rate)

Diaper service

Q: How does North Carolina compare to other states in taxation of services?

- Below average
 - In 2007, NC taxed 30 out of 168 services in Federation of [State] Tax Administrators study
 - 27 of 46 states (incl DC) with sales taxes taxed more services
 - SC and GA comparable; VA taxes even fewer; TN taxes twice as many
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Taxation of household services

- Taxation of household services more extensive than conventional wisdom might suggest.
 - But only half the states tax more than 20 of 40 household services in FTA list; only 5 tax more than 30.
 - HI, NM, and SD tax virtually all
 - Virtually all states tax restaurant meals, rentals of tangible personal property (e.g. videos) and transient accommodations.
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Are there reasons states might not want to tax certain services?

- Taxation administratively impractical/costly and/or substantial evasion likely
 - Service is a necessity that absorbs a large share of income of low-income families
 - Other social policy concerns
 - Sales taxation barred by federal law
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Approaches to expanding sales taxation of services

- Comprehensive (HI, NM, SD only)
 - All services defined as taxable unless explicitly exempted
 - Mirrors taxation of sales of tangible personal property (goods)
 - Incremental
 - State enumerates additional services it wishes to tax
 - Enumeration often occurs in definition of retail sale; “sale at retail includes [list of services].”
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Comprehensive extension of sales tax base to services

Pros:

- Major revenue gain
 - Eliminates need to continually revisit sales tax as new services are invented
 - Reduces enforcement/administrative issues in defining services and drawing lines between taxable and exempt services – and litigation
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Comprehensive extension of sales tax base to services

Cons:

- Immediately brings 000s of new vendors into sales tax system
- Likely to encompass many services that shouldn't be taxed for distributional or economic reasons; therefore likely to have to deal with lots of special pleading for
 - Exemptions from tax
 - Input exemptions to avoid excessive pyramiding

Incremental approach to extending sales tax base to services

Pros:

- Inherently requires deliberate consideration of which services state wishes to tax, permitting balancing of distributional, administrative, and other issues
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Incremental approach to extending sales tax base to services

Cons:

- Political – selected services will claim they're being unfairly targeted, with no underlying principle of taxation
 - Revenue gains may be modest
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Incremental approach to extending sales tax base to services

More cons:

- Problem of newly-invented services
 - Sales tax has to be constantly revisited because new services constantly being invented
 - Many newly-invented services will get a free ride until legislators get around to extending tax to them (if ever)
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Incremental approach to extending sales tax base to services

Still more cons:

- Can be difficult to write clear, water-tight definition of a specific service
 - So, have to devote resources to writing public education materials, regs, and “private letter rulings” for specific sellers
 - Sellers will litigate if they think definition vague enough to allow them to avoid charging tax
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Incremental approach to extending sales tax base to services

Likely to prevail despite significant drawbacks; states not willing to expand sales tax to all services at once

Mechanics:

- Will depend somewhat on specific written structure of each state's law
 - Enumeration often occurs as: " a 'retail sale' includes [list of services]"
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Broad or specific definitions of services under enumeration approach?

- Err on side of being as specific and detailed as possible
 - E.g. "Retail sale includes admission, equipment rental, and other fees for participant sports, which include but are not limited to bowling, batting cages, skiing, . . ."
 - Consider using standard definitions of services developed by fed. govt. for other purposes
 - North American Industry Classification System
 - North American Product Classification System
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Conclusions:

- No time like the present to seek inclusion of more services in North Carolina sales tax base
 - Can help address current fiscal gap
 - Base expansion preferable to rate increase on equity grounds
 - Essential to avoid long-term erosion
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