Sales Taxes on Services:
An Idea Whose Time Has Come?

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by

Laird Graeser
Director, Tax Research and Statistics Office
New Mexico Taxation and Revenue Department
and
Research Associate
Federation of Tax Administrators
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Introduction: In 1932, Mississippi, responding to a critical state revenue need, resurrected a very old idea -- the taxation of consumption through a tax on retail sales of tangible personal property. By 1939, 28 other states had joined with Mississippi in this "new" form of taxation. By 1943, the sales tax had surpassed the motor fuel tax to become the largest revenue source for state governments. Sales taxes continue to be the most important state tax, producing almost 1/3 of all state revenues.

With flying colors, the sales tax passes one of the most important tests of any tax: the tax produces adequate revenue, even in times of economic decline or depression. The tax, however, in most states fails some or most of the other critical tests: (1) the tax is not neutral, it distorts purchasing, manufacturing or other economic decisions; (2) the tax is regressive, imposing a higher proportional burden on relatively poorer households than on wealthier households; and (3) the tax is difficult to administer, causing controversy and litigation over largely arbitrary distinctions (is it a service or tangible personal property?). These failures have been known for almost as long as the sales tax has been in effect.

According to John F. Due, writing in 1950:

The taxes were drawn up hastily, with little thought to their exact aims beyond raising money, their economic effects, or the best structures in terms of the desired purposes. States introducing the levies subsequently copied the laws of the pioneers in the movement. Typically the taxes were regarded as temporary expedients, designed to raise money quickly, and destined for elimination once the depression was over.

As the initial enactments became permanent, the initial defects also became permanent. Of all the defects, the failure to tax services may be the most important. However, the states were wary in the early enactments of "taxing labor". In the midst of the depression, with high unemployment rates and jobs hard to come by, few governors or legislators were willing to be accused of taxing labor services and further burdening the laborers. Thus, the initial sales tax enactments, with few exceptions, exempted all forms of service.

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1 Due, John F. and John L. Mikesell, Sales Taxation: State and Local Structure and Administration; Baltimore: Johns Hopkins University Press, 1983, chart pg. 3
2 Mikesell, John. L., Sales Tax Coverage for Services -- Policy for a Changing Economy; to be published (March, 1990), pg. 1.
4 Due, John F., Retail Sales Taxation in Theory and Practice; National Tax Journal, III (December 1950), 314-322
5 The most notable exception seems to be New Mexico which enacted an "emergency school tax" in 1934. This tax was imposed for "the privilege of doing business in the state" and applied equally to sales of tangible property and services. The Washington, Indiana and West Virginia business and occupation taxes which also taxed goods and services and are still largely intact, were also enacted in this era.
6 Conversely, and fortunately for economic efficiency, most of the early sales tax statutes imposed the tax only on the final consumption (retail) transaction, and did not attempt to tax goods passing through the chain of commerce from raw material, through manufacture, distribution, and wholesale trade.
The paper presents a brief description of the economics of taxing services and details some of the recent state efforts to impose sales taxes on services. The seeming inevitability and arguments in favor of taxing services are presented. Some of the arguments that have been presented opposing the taxation of services are discussed along with the of the rebuttal of such opposition. Finally a summary and prediction of possible future movement in the area is presented.

**Economics of the Taxation of Services:** Economists classify the sales tax on retail sales of tangible personal property, despite many differences and difficulties, as a tax on consumption. Sales taxes are designed, in this theoretical view, to reach the consumption of households that receive income through transfer payments and bequests as well as through factor payments (interest, dividends, rents, royalties and wages). From this theoretical perspective, the purchase of consumer services is simply another form of consumption and the consumption tax should apply equally to goods and services purchased by households. No other theoretical framework captures the nature of the tax, and no other framework provides sufficient tests of the sales tax structure to be useful.

However, the political filter applied to the economics of the sales tax yields some peculiar hybrid taxes. As John Mikesell comments\(^7\):

> The sales tax base is subject to some logical boundaries, not all of them well respected in the political process.

When viewed in the framework of a consumption tax, the failure to tax services as they are consumed by households imposes what the economists call a deadweight loss, welfare loss or inefficient allocation loss. The tax only on tangible personal property distorts free market purchasing choices. These distortions mean that scarce economic resources of capital and labor are not as productive as they would be with a more neutral tax structure. For instance, if repair of tangible property is not taxed but purchase of a replacement item is taxed, then more consumers will choose to have property repaired. In response to this greater demand for repair services, relatively more economic resources will be allocated to provide repair services and fewer resources will be used to manufacture and distribute new items. This allocation is not optimum and economic growth will be slower.

**Within the construct of a consumption tax, there are potential distortions of another kind.** Most states tax machinery, goods and services used by a business in producing other goods or services for resale\(^8\). Economists call these goods or services used in the process producer goods or intermediate goods. If the

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8 States generally allow a deduction or exemption for goods physically included in a manufactured or distributed product. Goods passing through the chain of commerce from raw materials through manufacture, distribution, wholesale and retail sales are taxed only once at the final retail transaction. In addition to the resale exemption, many states specifically exempt manufacturing machinery or provide a refund or credit for sales tax paid on manufacturing machinery.
intermediate goods and services are taxed, the price of the final goods or service must rise to maintain adequate levels of return on capital. Alternatively, the return on capital must fall or wages paid to labor must decline. States generally tax tangibles sold to businesses when the tangible personal property is not physically incorporated in the production. For instance, the word processing computer purchased by the lawyer and the power saw and sandpaper purchased by the carpenter are taxed. The retail price rise is dependent on the relative amount of producer goods taxed, on the amount of vertical integration in the production process, on the form of business organization, on competitive factors and on industry specific markup practices. This general pyramiding causes the tax burden to be highly capricious and variable among industries and consumers with differing tastes for various goods and services. This problem is not specifically related to services but is pervasive within the usual structure of the sales tax. Taxation of services will aggravate this distortion.

In summary, existing state sales taxes impose greater or lesser deadweight losses on the state and national economy. On one hand, the sales taxes fail to tax services and on the other, they tax intermediate goods and services.

| Table 1: States Considering Taxing Services

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<tr>
<th>State</th>
<th>Description</th>
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<tbody>
<tr>
<td>Arizona</td>
<td>The recently published (1989) &quot;Arizona 2000&quot; report, among many other recommendations, strongly advocates that the state sales tax be expanded to services.</td>
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<tr>
<td>Arkansas</td>
<td>Considered broadening sales tax base to include professional services (e.g. attorneys, accountants, and advertising), but tax them at the rate of 2%, which is lower than the 4% state general sales tax rate. Two preliminary bills would have generated between $9.9 and $11.6 million. The final bill which passed the legislature in 1987, taxes only cable TV, interstate telephone and lease and rental services at the rate of 4%.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>In 1987, 1988 and 1989, Connecticut has added a number of services to its sales tax base. Public relations, fabrication, repairs to tangible property, custom computer programming, carpentry and painting, detective services, lobbying, janitorial services, health clubs and refuse disposal (among others) are now taxable. Construction services rendered on new construction are exempt from the tax.</td>
</tr>
<tr>
<td>Florida</td>
<td>In 1987, enacted a sales and use tax on a wide array of services, including many business services. On December 10, 1987 the Florida legislature rejected the law effective January 1, 1988. The sales tax rate increased from 5% to 6% on February 1, 1988.</td>
</tr>
<tr>
<td>Illinois</td>
<td>Upon his election in 1986, the Governor of Illinois proposed the broad taxation of services, and a reduction in the sales tax rate. The proposal was withdrawn after it met stiff opposition.</td>
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<tr>
<td>Indiana</td>
<td>In 1987, the Governor proposed major base expansion but the proposal was immediately dismissed by the legislature.</td>
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<tr>
<td>Kansas</td>
<td>An interim legislative committee met through the summer and into the fall of 1987 to consider sales and use tax reform. One issue was the potential expansion of the base to include services, broadly defined. Legislation was introduced in both houses in 1990. Some bills would tax a few mixed services. Other bills proposed broad ranging taxation. Some further consideration of the concept is expected during the interim of 1990.</td>
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<tr>
<td>Maine</td>
<td>In 1986, Maine broadened the base to include telephone access charges, auto rentals and other selected services.</td>
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<tr>
<td>Kentucky</td>
<td>In 1985, Kentucky extended the sales tax to equipment leases and rentals. In 1990, in order to address a court decision declaring unconstitutional the school finance arrangements, the legislature enacted $1.4 billion in new revenues. Originally, one proposal introduced would have imposed the sales tax on &quot;luxury services&quot; such as accounting and legal services. This proposal died virtually on introduction. The sales tax rate would increase from 5% to 6%.</td>
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<tr>
<td>Massachusetts</td>
<td>In an effort to solve serious revenue problems, the Senate passed a bill (May 1990) extending the 5% sales tax to mutual fund management fees, accounting, legal services, and public relations. Following the wisdom of Connecticut and Florida, advertising services have not been included.</td>
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<tr>
<td>Minnesota</td>
<td>The House, Senate and Governor all considered proposals for sales/use tax reform in fiscal year 1987. The Governor's proposal would have included taxing non-profit groups and sales to state and local governments. The final compromise extended the base to include activities such as security services, lawn care, non-prescription drugs, pet grooming and laundry and dry cleaning.</td>
</tr>
<tr>
<td>Nebraska</td>
<td>A base broadening proposal was considered, in 1985, that was as comprehensive as the original Florida proposal. The bill was eventually withdrawn due to opposition. Some minor services are now taxed, including cable TV and some utilities.</td>
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<tr>
<td>New Jersey</td>
<td>In March 1990, the Governor introduced a proposal to extend the sales taxes to telecommunications, cable TV and commercial building maintenance services. The package passed the legislature all except for cable TV. Implementation date is July 1, 1990.</td>
</tr>
<tr>
<td>New York</td>
<td>In an effort to balance a budget seriously out of balance, the Governor and the legislature were reported to have agreed to extend the sales tax. Magazines, 900 numbers, custom computer programming, public relations, cleaning services, and management consulting were included in the agreement. Taxes on these newly enumerated services were expected to make up about an eighth of a $4 billion revenue gap in the 1990-91 budget. The proposal and agreement were later scrapped.</td>
</tr>
<tr>
<td>North Dakota</td>
<td>In 1987, the cable TV lobby used a referendum procedure to block a tax on such services; the base expansion proposal will be subject to a popular vote in 1988.</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>A 1987 proposal to broaden the sales tax base and capture $200 million in additional revenues was not passed by the legislature. A scaled down version was also rejected.</td>
</tr>
<tr>
<td>Texas</td>
<td>A $2 billion base broadening proposal was introduced into the legislature in 1987 to meet the deficit crisis induced by the decline in the oil and gas industry. The bill did not pass the legislature, and the sales tax rate was increased from 5.25% to 6% effective Oct. 1, 1987. Some select services were added to the base, including credit reporting services, debt collection services, insurance services and real property services. Effective Jan. 1, 1988, the base will include data processing, real property repair and remodeling services. Finally, a two-year professional occupations tax of $110 was imposed on doctors, architects, engineers and some other professionals.</td>
</tr>
<tr>
<td>Washington</td>
<td>A proposal to extend the sales tax base to include most services (except medical and financial), and reduce the sales tax rate from 6.5% to 6% did not pass the legislature. The proposal would have generated $500 million over the 1987-89 biennium, with the proceeds earmarked for higher education.</td>
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<tr>
<td>Washington, D.C.</td>
<td>In 1989, the mayor of this major city (quasi-state) proposed taxing numerous services, including business services. In two months from introduction to passage, the council approved taxes on landscaping, janitorial and maintenance services, information and data base services. The taxes went into effect July 1, 1989. Further expansions of the base have been proposed.</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Jeffrey Neubauer, a liberal Democrat state representative proposed taxing most personal and business services as a way to replace a real estate tax that was considered too hard on lower-income families. &quot;He couldn't get the political mileage to justify the beating.&quot; (1987)</td>
</tr>
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**State Initiatives to Tax Services:** Individual states have sporadically attempted to rectify the first of the serious problems by proposing to extend sales taxation to some or many services. Generally,
these extensions have been in response to a revenue need and not a desire for tax reform. Within the past five years, no fewer than 18 states have proposed extensions of the sales tax to embrace at least some services. Most of these efforts have failed. In the Florida example, the tax on a broad range of services (business and personal) was in place for six months and then repealed. Even in the few cases where the base was broadened (Connecticut, Texas and Minnesota) the taxation of services has been less extensive than originally proposed.

State legislatures, governors and finance officers will continue to flirt with the idea of extending the sales tax to include some or many consumer services and some or many business services. This flirtation will be consummated in a few states as sales taxes will be imposed on services. According to Hal Hovey writing in State Policy Reports.10

There are many reasons to expect that broadening the sales tax to consumer services will be popular in the 1990's. The result: (1) is widely predicted, (2) appears to be a trend, (3) is supported by economic considerations, and (4) may have manageable politics.

**Argument for Taxing Services:** There is a continuous chain of logic and speculation that explains the attraction of sales taxation of services by states. This conventional wisdom runs as follows:

States will be under continuing pressure for permanently expanded revenue throughout the 1990's. Unfunded federal mandates, uncontrolled Medicaid costs, continuing double digit increases in corrections costs and school funding formula problems must be solved. Constituencies seeking expanded spending by states are more numerous and more vocal than constituencies organized to limit state spending. Given the choice of cutting spending or increasing taxes, it is more likely that many (if not most) states will elect to increase taxes. During the 1980's, the states, by and large, managed their budget problems. In the 1990's the states must solve their budget problems.

The problem for each of the states is where to find the revenue to support existing programs and implement new ones. There are really only four taxes with sufficient revenue potential to permanently address the need: severance taxes, property taxes, income taxes and sales taxes.

Severance taxes are generally unreliable, variable revenues, changing with the economic and political climate. Only 11 or so states have significant natural resource exploitation to be important for revenue.

Although the property tax has recovered some of its glamour and revenue growth since the days of Proposition 13 in California, Proposition 2 1/2 in Massachusetts and other "tax revolt" measures, legislatures and the political process have long memories of cataclysmic events. It is highly unlikely that state or local governments will permit property taxes to rise to previous levels -- either in real terms or in terms of share of total state or local budgets. Economic development officials concerned about business climate,

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10 Hal Hovey, *Broadening the Sales Tax Base*; State Policy Reports, Vol. 8, Issue 3 (February 1988)
the technical community, and citizen awareness of the burden of property taxes on middle income taxes will all serve to reinforce limits on utilization of the property tax.

By the very nature of the property tax, there will always be regions of more property wealth and therefore property tax, and areas of low property tax value and tax yield. This disparate property tax yield causes problems where the property tax is the primary means of financing local schools. Parent groups in many states have sued states and local jurisdictions alleging that public school funding methods that result in highly disparate expenditures per pupil violate state constitutional guarantees. As more and more local public education lawsuits are successful, the local property tax will recede in importance for funding school systems. Statewide property taxes, strong equalization mechanisms and equitable, state supported school funding will all contribute to a lowered role of the local property tax and subject the property tax to continuous statewide scrutiny and, realistically, to significant limits of growth.

Personal income taxes are income elastic. That is, the tax collections increase at a faster rate than the growth in personal income. Hence personal income taxes are good revenue generating machines. Additionally, personal income taxes are progressive and adhere to the "ability to pay" philosophy. However, there are strong interstate competitive factors that limit the unbridled use of the personal income tax. The literature indicted high top marginal rates as a significant inhibiting factor in industry decisions to relocate or expand in a state. A 10% top marginal rate\(^\text{11}\) seems to be the highest that is politically feasible. Most income tax states will continue to respect this limit.

Because of federal action, a significant amount of personal income tax reform, including income tax base broadening, has been adopted by the states. Since most income tax states adopt the federal definitions of income and deductions, the 1986 Federal Tax Reform Act has generally broadened the income tax base for the states. Some states adopted rate relief as they adopted the broader base, some did not. In the future, these rate reducing states may choose to increase rates. There is not a great deal of scope for states to adjust state deductions or exemptions. A state income tax closely tied to federal income and deductions is the most administrable at minimum cost. In addition to administrative concerns, the courts have addressed some state base adjustments. Subsequent to the Federal Supreme Court decision in Davis v. Michigan, many states have responded by eliminating or restricting the tax expenditure on public pensions.

One particularly popular method of managing the budget problems of the 1980's was the institution and administration of "user fees" and "service fees". These user fees have tried to impose the cost of providing service on the consumers of the service. Unfortunately, the revenue potential is small. The real problem in state finance is obtaining sufficient revenue to support broad spending programs that are clearly a public responsibility and not amenable to user charges. It is difficult to figure how to impose user fees on

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\(^\text{11}\) Only Montana with a top nominal rate of 12.1\% and Hawaii with a top rate of 10\% equal or exceed this limit. Montana's top rate when adjusted for state deductibility of federal taxes is 8.71\%. Source: The Unfinished Agenda for State Tax Reform; Steven D. Gold ed, National Conference of State Legislatures, Denver, (1988)
Medicaid charges, corrections, or public school support. The only significant area of potential growth of user fees -- public school tuition fees -- may not be legally or politically feasible.

Excise taxes, particularly motor fuel, tobacco and alcoholic beverage taxes, will be increased in most states during the 1990's. However, gasoline taxes have traditionally been earmarked for highway funding and are not generally available for general fund expenditures. The revenue potential of the sin taxes is moderate, and the tax bases for both tobacco and alcoholic beverages are declining. Although the rates will increase in the 1990's, there is simply insufficient revenue potential in these commodity taxes to address the larger funding problems.

Business taxes -- business and occupation taxes or corporate income taxes -- share some of the same features of sales taxes imposed on intermediate goods and services. Increases in any of these taxes can be partially hidden as price increases in goods and services. Further, the taxpayer has some control over the quantity of goods consumed at any particular income level. Thus, the political popularity of business impositions may permit increases in these areas. There are stability and economic neutrality problems as well as strong business climate and economic development issues that argue against major increases in business type taxes.

Thus, by elimination, the sales tax may be the state revenue source of choice for the 1990's. In particular, the choice is base broadening or rate increases. Tax increases are always fraught with political risk. Legislators and the electorate seem perversely to agree that a rate increase is a tax increase, while there is much less agreement that base broadening constitutes a tax increase. Base broadening, if successfully presented as tax reform, might end up being politically helpful.

At this point, the conventional opinion breaks down. Surely, in the 1990's, state governments will be strongly attracted to sales tax base broadening as a method to resolve revenue problems. Just as surely, this seemingly attractive course traverses largely uncharted political territory. No large industrial state has been notably successful in the effort to broaden its sales tax base to include services much beyond utilities, transient accommodations, rentals, admissions or repairs to tangible property. This evident historical failure underscores the political difficulty of imposing a radical alteration in tax philosophy.

In summary, then, there is a certain reluctant inevitability to taxation of services. States uniformly will need revenue in the 1990's to solve long standing problems of increasing demand for services, increased federal and court mandates, and decreased yield of sales taxes. In terms of tax policy, the neutrality of the sales tax can be improved by including a broad range of consumer services. To the extent that intermediate

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12 For a general description and classification of level of taxing services see Mikesell (1990), op. cit., Due and Mikesell (1983) op.cit., or FTA Survey of Sales Taxation of Services, Federation of Tax Administrators, Washington D.C. (1990). New Mexico, Hawaii, South Dakota, Washington, West Virginia and Iowa lead the list, ranked 1 or 2 by Due and Mikesell. None of these can be considered "major players". The major states with most significant levels of taxing services -- Texas, Connecticut, Wisconsin, Minnesota and New York -- are classified by Due and Mikesell as 3 or "substantial taxation".
business goods and services are already taxed, an expansion of the sales tax base to business services will merely aggravate an already undesirable situation but maybe with minimum damage. To the extent that in-state businesses ship goods out-of-state, the taxes are export ed and imposed on out-of-state purchasers of the goods.

**Arguments Against Taxing Services:** States floating proposals to tax services must be very careful what services they propose to tax and what counter-arguments will be promoted by those affected. The economics of the proposals will bear little, if any, relation to the political acceptability of the process. In each of the states that have recently proposed taxing services, the arguments against run along similar and familiar lines: old tax/good tax, Florida, regressivity, taxpayer preference and equity of taxing producer goods. All good arguments have some plausibility. The arguments against taxing services are no exception.

**Old Tax/Good Tax:** For most politicians and taxpayers, an old tax is a good tax. In substance, this position argues that known evils are better than unknown evils. It is better to increase the tax rate on a known base than to extend the reach of the tax into the unknown. Who knows what problems will surface if the tax plumbs the unknown. There is some technical merit from the administrative side in this proposition. In the years since passage of the first sales tax in each state, taxpayers, the state courts and the tax departments have achieved some collective agreements about administration, taxpayer remedies, taxability of particular transactions and so on. Consumers and businesses have learned to live with the tax. Imposing a radical change to past agreements will not be viewed with favor by most of those involved. While businesses want stability of tax rates, they also need and want stability of tax base. Investment decisions are conditioned on what is taxable and what is not, at least as much as on what the tax rate is. In many cases, the sales tax is passed forward to consumers, so that the tax rate is not particularly important in expansion decisions. However, to the extent that business purchases of goods or services are taxable, both the rate and base are important. Changing the rate or base has the potential to affect profitability and causes investment decisions to be altered.

In support of the "only good tax is an old tax" position, John Mikesell\(^\text{13}\) quotes Richard Rose\(^\text{14}\):

> Whether or not the existing tax structure is optimal from an economist's point of view, it is usually optimal from a politician's point of view. Doing nothing but upholding the law of the land enables a politician to avoid identification with proposals to levy new taxes or increase the rates of existing taxes. If keeping out of trouble is a basic law of politics, then not making decisions is one way to avoid trouble -- in the short run at least. Introducing new taxes and repealing established taxes cause political controversy and uncertainty about revenue flows without necessarily augmenting the revenue of the fisc.


However, almost as important as the economic argument opposing the extension of the base is the "camel's nose in the tent" argument. The theme of this criticism is that although all revenue is equal, some revenue is more equal than others. Some sources of revenue will go to government's head. If taxpayers let the government tax whatever it proposes, the government will propose taxes on more and more transactions. Some business representatives argue that the expanded sales tax will be inflationary, will cost jobs or cause other economic disasters. In reality, the arguments have little technical merit but a great deal of political savvy, playing on taxpayer and business anxiety.

**The Florida Experience:** Most of the economic and political arguments against extension of the sales tax base are tinged by the repeal of the Florida statute. At least one writer has referred to the enactment and repeal as "a fiasco." Dave Barry, widely syndicated humorist for the Miami Herald, wrote in a fictional year-in-review piece in late 1987:

> March 11 - Florida Gov. "Bob" Martinez, who ran for office on a platform of OPPOSING taxes, announces that he will SUPPORT the new tax on service, until it is passed, then he will call for a referendum so voters can vote AGAINST the tax, although he will campaign FOR the tax, but then he will change his mind and announce that he is calling a special session of the legislature to REPEAL the tax. Everybody naturally assumes that the governor is joking.

It was probably the coalition of powerful and articulate elements with strong media access that ultimately brought down the Florida tax. Whatever the cause of the downfall, opponents of the concept in other states will continue to parade the Florida experience. In some instances, this bogeyman scenario will effectively forestall base expansion. In other states, proponents will learn from the Florida problems. James Francis advises other states of three fundamental lessons gleaned by the actors in Florida:

1) the piecemeal approach to service taxation is not the appropriate method because the politically toughest, but most important measures, will likely never be taken;

2) a method must be found to make the self-serving, anti-tax posture of the media obvious for what it is. (One approach would be to tax advertising sales in a separate bill, after a general service tax has been implemented and accepted by the public, another would be to tax advertising in a different -- yet constitutional -- manner, such as by denying the deductibility of advertising and promotional expenses for income tax purposes; and

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17 James Francis, Director of Tax Research for the Florida Department of Revenue, analyzed the chronology and factors involved in the Florida experience in the article *The Florida Sales Tax on Services: What Really Went Wrong* in *The Unfinished Agenda for State Tax Reform*, Steven D. Gold, ed. NCSL, Denver (1988). In brief, Mr. Francis asserts that the three key logistical mistakes led to the downfall of the tax, more so than any defects in the tax itself. These three mistakes are (page 142):
   1) The governor's campaign rhetoric gave opponents an anti-tax message that was sellable to the electorate;
   2) The media, aggravated by inclusion of advertising services within the tax base, were too happy to bombard Florida's households with that message; and
   3) Ill-conceived responses by leaders within both parties dissolved the coalition supporting the tax before an effective counterattack could be mounted.
3) it must be recognized from the outset that the pro-tax coalition must proceed on a consensus basis both before and after enactment.

Regressivity: The rallying cry against sales taxes generally is that they are regressive. While virtually all analysts and observers agree that consumption taxes are regressive, there are several persuasive explanations and remedies to the problems posed by the regressive sales tax, particularly in conjunction with a proposed increase in taxation of services.

First, an increase in a regressive component of the total tax mix can be matched with a corresponding increase in a progressive component or a decrease in another regressive tax. Thus, states may choose to balance sales tax base broadening with property tax relief, personal income tax increase, or sales tax rate decrease. The regressivity and balance of the total tax structure are the important points here, not the characteristics of a single tax.

Second, the inclusion of selected services can lessen the regressivity of a retail sales tax imposed strictly on tangible personal property. Utility services, coin operated laundry services, car repairs and towing services are consumed as a greater percentage of total family income by the less well off than by the wealthy. Conversely, parking services, home improvement and maintenance services, accounting services, hotel/motel lodging and landing and docking fees are disproportionately consumed by the wealthy. The tax base could include those services with progressive expenditure patterns and exempt those with regressive patterns. Of course, selective inclusion in the tax base violates the principles of horizontal equity and neutrality.

Third, there is no substantial agreement among analysts as to how regressive the typical sales tax is. The numerical and analytical measure of regressivity is critically dependent on a number of technical factors. The income used in the denominator of the share computation should include transfer payments (social security, welfare, unemployment compensation and worker's compensation) as well as factor income (wages, dividends, interest, rents and royalties). The most appropriate unit is not the individual consumer or taxpayer but the family unit. Consider the case of a single college student, living on campus with a part time job, with tuition and living expenses financed from the parent's resources. The student's income is very low, while total expenditures are high. Sales taxes as a percent of income may be very high as a percentage of income. For an analysis of tax incidence and regressivity, it is most appropriate to group this student with the supporting family economic resources. This aggregation to family unit is not always done in tax burden or incidence studies.

On average, the lifetime incidence of a broad based consumption tax is only slightly regressive. That is, individuals adjust their spending patterns to approximate their long-term economic power and consume proportionately to this long-term expectation of income. Over a lifetime, total income is consumed minus whatever wealth is left for heirs and other bequests. There may be periods in each individual's lifetime
that are saving periods and other times that dissaving predominates. Aside from the issue of bequests, lifetime consumption is proportional to income. Assuming that all consumption is taxed equally, lifetime consumption taxes are proportional to lifetime income. The sum of estate taxes and broad based consumption taxes may even be slightly progressive. The steeply regressive low income tail exhibited by tax burden studies may be populated primarily by temporarily poor individuals. Some studies have used annual consumption expenditures on non-durables and services as a proxy for permanent income. In any event, the design of the income measures affect the conclusions and policy makers should be wary of the methodology reported by various analysts, particularly when very large regressive effects are reported.

Fourth, the regressivity of the sales tax in any state can be addressed with targeted rebates administered through the income tax system. A number of states provide this form of tax relief\textsuperscript{19}. The two most popular forms are the fixed dollar rebate available to all qualifying taxpayers or a rebate that declines with increasing income. In either case, the qualification can be measured by adjusted gross income, by family income including otherwise non-taxable income or by wages or other earned income. The rebate must be refundable and the income tax system must be capable of administering a large number of tax returns filed only for the rebate. New Mexico, for example, which offers rebates for taxpayers with family income less than $16,000\textsuperscript{20}, will process over 220,000 rebate tax returns in a total filing population of 660,000. Although the administrative burden is increased it is not a major cost issue, since it involves relatively low levels and low cost of non-compliance. Significant administrative resources must be devoted to taxpayer information to assure a high percentage of eligible low income taxpayers actually file for rebates.

Fifth, states may choose to address sales tax regressivity through adjustments in income support or other transfer payments. States can increase welfare, medical indigency payments, job training or unemployment benefits to compensate for the sales taxes on lower income taxpayers.

\textbf{Public Preference:} Public preference surveys indicate that despite increasing sales tax rates, the public continues to support sales taxes over property taxes or even income taxes. The choice of base broadening is not as popular as rate increase, however. This may have been instrumental in the quick demise of the recent Kentucky proposal to tax services.

\textbf{Equity of Taxing Producer Goods:} The analysis of taxes or tax systems includes a number of tests. One of these tests is horizontal equity. Two taxpayers in similar circumstances should pay about the same amount of tax. Sales taxes, in particular sales taxes on services applied to interbusiness transactions, are particularly vulnerable. The arguments have been stated earlier in this paper. Opponents of the tax exten-

\begin{footnotesize}
19 Six states, Hawaii, Idaho, Kansas, New Mexico, North Carolina and Vermont provide rebates of some form.
20 The New Mexico food and medical rebate is $52.50 per allowed exemption for married individuals with income to $9,000 or single individuals with income to $6,000. Scaled down rebates are allowed for income to $16,000 for married individuals or $12,000 for single individuals. In addition, a Low Income Comprehensive Tax Rebate is allowed taxpayers with income as much as $10,000. A table provides an amount of rebate for each income level and each allowed exemption total up to 6 total exemptions. Income is defined as "modified gross income" which includes gifts, welfare and unemployment payments and otherwise non-taxable social security income. Business or rental losses are disallowed.
\end{footnotesize}
sion quote scripture here with good cause. There are material distortions caused when businesses consume services and pass the tax forward or backward.

On the other hand, the taxation of business services without regard for the business or household destination of the services, generates substantial revenue compared to a tax imposed only on tangible personal property or on tangible personal property and consumer (personal) services. Taxation of strictly consumer services increases total yield of the sales tax only slightly\textsuperscript{21}. States in search of revenue typically need significant revenue to offset the political damage of the tax increase by corresponding spending increases directed at client groups. There is incentive to go for the revenue option rather than the economically sound and correct solution.

**Prediction:** the issue of sales taxation of services will not go away. Undoubtedly, political inertia will make the process very slow. Florida's experience will intimidate other states. John Mikesell is skeptical that the process can heal itself or that states will actually impose base extensions\textsuperscript{22}:

...there is little reason to expect a movement toward general coverage of services. There has been no such movement in the past and the Florida misadventure provides no encouragement for political bravery. Given the coverage of business input cost that would result, this is fortunate -- except that it may delay substantial coverage of individual service purchases as well.

However, many of the same forces that compelled states in the 1930's to quickly adopt the sales tax are operative in the 1990's: large revenue needs demanding more tax revenue; disaffected electorate; and a continuing emphasis on tax reform. If a major industrial state establishes a workable, economically sound, politically astute extension of the sales tax to services, other states may soon flock to the banner.

It is not difficult to predict that the preference will be for taxation of both business and personal services over a conservative, economically sound, consumer services based tax. Considering state revenue needs and political realities, the odds favor a mixture of business and personal services with only slight acknowledgment of sound economic principles. The odds further favor a patchwork of illogical exemptions and capricious inclusions.

Administratively, a vendor tax is easier to administer than a consumer tax,\textsuperscript{23} and has other advantages as well. Administrators must be prepared to help the transition from the current economically and administratively flawed system to a new system with other economic and administrative flaws. With the leader-

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\textsuperscript{21} Due and Mikesell, 1983, op. cit. report that revenues would increase 2% to 15% with the inclusion of most consumer services.

\textsuperscript{22} John Mikesell, Reforming and Restructuring; op. cit., page 12.

\textsuperscript{23} Tax on vendor is administratively easier: definitions are easier (location of tangible property, commercial domicile, location of construction, location of service performance, product of service delivered out of state, first use of service within the state, etc.); allows potential taxation of federal contractors; cleans up lien and levy problems; provides automatic relief against bad debt issues (vendor income taxable only when recognized; cash basis taxpayers pay tax when payment on goods received, accrual basis taxpayers pay tax when income recognized. Taxpayers with bad debt reserves decrease recognized income by amount of bad debt charged.)
ship of tax administrators, perhaps the administrative and economic realities will be kept in mind in the political debate.

Because of more favorable politics, it is possible that states will be most successful in imposing taxes on services if it is done in the context of tax reform than if it is done in the environment of tax increase. Conversely, Hal Hovey in State Policy Reports predicts that the time to move on the issue is in the midst of a revenue shortfall or at least when the base broadening can be characterized as "loophole closing":24

Governors often like broader sales taxes when presented as "loophole closing." Recently Maryland’s governor suggested rate increases were out this year but said he might seek "equitable, fair, plugging up of some loopholes that should have been done before anyway. Because the shortfall in revenues in many states is in sales taxes, plugging loopholes there has the appeal of only letting the state collect as much as was assumed in a prior budget.

States have a number of choices in designing legislation to impose taxes on services. The two most important choices are the situs of services and the compensating use tax imposed on services. New Mexico determines the taxable location of where the services are performed. Other states including the statute in Florida, utilize a destination principle. The services are taxed, not where performed, but where utilized. The destination principle may be somewhat more difficult to administer but is more in keeping with the pattern of many years used in the taxation of corporate income using a sales factor in an allocation formula. This debate conditions all the other choices. In particular, legislatures must be concerned that in-state service businesses are not at a competitive disadvantage compared to out-of-state service providers.

This "level playing field" almost mandates that a compensating use tax on services be imposed. In most cases the destination principle and the compensating use tax will be easily determined. In others, the choices will become much more difficult.

Finally, states making broad movements in the taxation of services may be tempted in the initial enactment to avoid extension of the tax to cover certain articulate and technically knowledgeable constituent groups and to avoid "finger holds" for emotional attacks on the base broadening. While this may be politically astute, the momentum of revenue need may argue that the broadest imposition with the fewest number of exemptions is the fairest. Despite this general principle states may wish to defer consideration of taxing advertising because of media access, lawyers and accountants because of technical knowledge and medical services because of "tax on misery" arguments.

24 Hal Hovey, Broadening the Sales Tax Base; op. cit., p. 6
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