Sales Taxation of Services:
A Review of the Issues

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A Review of the Issues and Presentation of the Alternatives

Introduction:

In the course of the decade of the 1990's, it is possible, even probable, that states, counties and municipalities will impose sales taxes on a broad range of services. This result has been widely predicted, states have critical revenue needs that must be addressed with increased taxes and this approach to new taxes is perhaps the least unpopular of a range of unpopular choices. However, it is not at all certain what form the new taxes will take, considering the broad range of existing sales tax, gross receipts or business and occupation taxes. This paper attempts to explain the issues involved in imposing sales taxes on services.

One major characteristic of the sales and business transaction taxes in all states is that the principle of economic neutrality is violated. The sales tax burden causes purchasers, to a greater or lesser extent, to make different purchasing decisions in the face of the tax than they would without tax. This distortion means that scarce economic resources are not allocated in the best way. This misallocation puts a crimp in state economic growth. However, no tax is perfect; no tax is perfectly neutral; all taxes cause some misallocation of economic resources. Is the sales tax better or worse than other taxes in this regard? Perhaps, more to the point, would an extension of sales taxes to embrace taxation of services improve the sales tax or cause further distortions?

An excellent description of the general problem is contained in the early writing of John F. Due:

There has been a tendency to confine sales taxes, especially of the single stage character, to sales of commodities, that is of tangible personal property, thus excluding the rendering of services. Most of the American state sales taxes do not apply to any services or to only a few categories. From an economic standpoint the distinction between a service and a commodity is not a very significant one, since both satisfy personal wants. A haircut, an opera concert or a plane ride satisfy personal

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1 One of the characteristics of the state taxation of services is the variety and statutory creativity of the enactments. Thus states have imposed rental taxes, meals and lodging taxes, transient accommodations taxes, public service utility taxes, utility gross receipts taxes, telecommunications taxes, admissions and amusements taxes, mechanical game taxes, etc. In addition, some states impose business and occupation taxes on the gross receipts of businesses in the state. To the extent that these latter taxes are shifted to consumers or in-state factor inputs (interest, dividends and wages), they bear remarkable similarity to sales taxes. To the extent that they are a tax on exports, there are differences. In this paper, when "sales taxes" are specified, the other statutory forms of taxing the gross proceeds of a service transaction rather than the net income of the service business are included.

2 Among other predictions: Steven Gold in The Unfinished Agenda for State Tax Reform; Steven Gold, eds., National Conference of state Legislatures (1989); Harley Duncan, Executive Director of Federation of Tax Administrators, quoted in the Wall Street Journal, 11/8/89; Governing 12/88; and others. John Miksell, (Reforming and Restructuring State General Sales Taxes: What Now?; a paper prepared for the Association for Public Policy Analysis and Management (Oct. 1988)) is less certain that a trend is developing.


4 John F. Due, Sales Taxation; (1957), 297
desires in the same manner as a loaf of bread, a piano, or an automobile. Obviously services rendered to business firms, whether by employees or commercial service establishments, are not suitable bases for a sales tax, since they are essentially producer's goods, and do not in themselves satisfy personal wants. But the failure to include services rendered to consumers gives rise to the same objectionable results as the exemption of specific commodities. Persons making relatively high expenditures for services are favored compared to those concentrating their purchase on tangible goods, resource allocation may be distorted, and in some cases administrative complications are created. This is particularly true when services are rendered by establishments also selling commodities; the line of distinction between service and commodity is by no means a sharp one, and the two may be provided jointly, particularly in the case of repair and fabrication service. Any sale, of course, involves the rendering of some services (that of the merchant, for example, with a retail tax); when services as such are not taxed, the line of demarcation is not actually made between commodity sale and the rendering of service, but between the type of services regarded as typical merchandising activity and another type, which is not so regarded. The drawing of this line of distinction is highly arbitrary, and gives rise to a number of administrative problems. Especially with the retail sales tax, in which the problems are most acute, so-called service establishments encounter greater difficulty with the application of the tax than any other type of business. The service industries require the greatest number of special regulations and rulings and the greatest care in inspection.

Those [services] generally regarded as unsuitable for taxation on grounds of general social policy include medical and dental service, hospitalization, education, housing, local transportation, and other categories. For purely administrative reasons it is virtually impossible to include the work of personal servants, foreign travel and some other items.

Thus there remains as suitable for taxation a range of services normally rendered by commercial establishments, such as public utility service, admissions to places of amusement, rentals of transient accommodations, repair work of all types, fabrication (such as the work of a merchant tailor), dry cleaning, laundry, barber and beauty shop work, photofinishing, pest control, etc. Building contracting can also be included. Inclusion of these categories simplifies administration of the tax for the most part, eliminates discrimination in favor of persons who spend relatively large percentages of their incomes for these services and increase the tax revenue at a given rate.

These and other issues will be discussed in the framework of prototype sales tax systems. First, the consensus or median sales tax system will be discussed. Then the three most plausible prototypical extensions will be developed. A general discussion of tax policy criteria will be presented. Finally, the three prototype extensions will be graded against the tax policy criteria.

**Consensus Sales Tax Structure:**

Idaho, Ohio and Oklahoma are the mid-range states in terms of breadth of service taxation based on the "long list" of services described in a companion paper⁵. Based on the short list discussed in the same reference, Nebraska, Ohio, Oklahoma and Pennsylvania are equally mid-range. For simplicity, Ohio and Oklahoma will be used to describe service taxation in the median state. Ohio taxes installation and repair of items of tangible personal property. It taxes inter- and intra-state telephone service but exempts other utilities. Diaper service is taxable as is tuxedo rental (based on the rental charges and not on the purchase

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price). Photocopying, printing and photofinishing are taxable. All amusements and admissions are exempt. Repairs to real property are exempt. Oklahoma, on the other hand, does not tax repair and installation of real or tangible property. However, the state taxes taxi and train transportation, parking, telephone, non-residential electricity and natural gas utility services, tuxedo rental and commercial laundry services, photocopying, printing and photofinishing, and a broad range of admissions and amusements.

Ohio is considered a state with "substantial" taxation of services on the John Due ranking scheme. However, it is at the very lowest edge of this ranking. Ohio ties its tax strictly to the relationship with tangible personal property. Oklahoma is a state with "little or no" taxation of services. However, this ranking is conditioned strongly by the failure to tax repairs and installation.

The consensus level of taxation is at a cusp. One example includes repair services and the adjacent median state does not include repair services but does include other services. For simplicity, one pattern is chosen, the Ohio model. The median level of service taxation then includes modest taxation of utility services, printing, photocopying and photofinishing, some repair services to tangible personal property but no real property services, no taxation of admissions and amusements or transportation services.

**Economic Considerations of the Failure to Tax Services:**

Almost exactly half of the states fail to tax repairs and installation, the simplest and most economically justifiable extension of tax to services. States failing to tax installation and repair of tangible property must seriously consider whether their sales taxes are not distorting the consumption decisions of consumers with regard to replacement or repair. If repair services are exempt and new purchases are taxable, consumers will tend to repair tangible property rather than replace. This subtle change in decisions has an equally subtle influence on distorting the allocation of capital and labor to repair businesses that might more efficiently be allocated to manufacturing and retailing establishments.

Similarly, failure to tax utility services provides a subsidy for consumption of energy against consumption of tangible property. Because electricity, for instance, is cheaper by the amount of tax break, the decision to purchase a high efficiency refrigerator is slightly less attractive. An endless chain of these "either-or" decisions can be described. Even states with higher levels of taxation of services than the median may undoubtedly be effected by economically inefficient deductions and exemptions from the sales tax.

Failure to tax admissions and amusements distort labor/leisure decisions. By making leisure and recreation expenses slightly less relatively expensive, workers will tend to provide a slightly lower levels of work. Wage rates will tend to be slightly higher and cost of goods will be slightly higher.

Although most states create distortions in the direction of inadequate taxation of services, there are other economic distortions that are characteristic of most state sales taxes. Taxation of intermediate goods has
annoyed economists ever since the discipline has been organized; certainly since the advent of the modern sales tax in the early 1930's. If the purchases of a business are taxed, then the tax cost will be variably and capriciously passed to consumers, to labor or to capital. The burden is capricious because the level of tax on a particular service or commodity depends on the number and kind of intermediate goods and services consumed by a business in producing the good or service sold to the final consumer. For instance, if a business purchases a taxable machine to make its product, then the tax cost reflected in the price of the product depends on the cost and efficiency of the machine, on its estimated life and on competitive factors.

The taxation of intermediate goods is frequently termed pyramiding. The more extensive the pyramiding and the higher the tax rate, the larger the distorting effect of the tax system. States have made a number of adjustments to ameliorate the extent of pyramiding in the sale of tangible property. In many states, manufacturing machinery is exempt or the tax paid is credited or rebated. In almost all jurisdictions, only the final retail sale of tangible property is taxable. Sales from manufacturer to jobber, jobber to wholesaler, and wholesaler to retailer are exempt from tax. The states usually term these exempt transactions "sale for resale". This general exemption is not true of goods or services purchased and consumed by business but not physically included in the manufactured product. Thus an adding machine, or electricity, or business lunches purchased by a business are taxable and not subject to the usual sale-for-resale exemption. The physical inclusion test virtually eliminates a sale for resale exemption of service. Thus virtually all taxable services will be directly or indirectly taxable to businesses purchasing those services. Only New Mexico and West Virginia allow service-for-resale exemptions and the New Mexico exemption does not solve the pyramiding problem.

Neither type of distortion is large (pyramiding or failure to tax companion consumption of services) and neither is easy to measure or document. Balanced against the welfare cost to the state economy are the elements of social policy or equity addressed by exemptions. Because of the economic defects of the current sales taxes addressed by expansion of sales tax to services, in many cases, the expansion of sales tax coverage to taxation of service can be an element of tax reform. In these instances, the taxation of services can effect an improvement in the economic distortion and an amelioration of the dead weight losses. In other circumstances, particularly where the increased base results in greater pyramiding, the distortions will increase. State policy makers must develop more insight into the effect of the sales tax on consumption decisions and deadweight losses before acting.

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6 Mississippi enacted the first modern sales tax in 1932. By 1935, 28 states had enacted sales taxes of some kind. Six of these enactments had expired by 1936. However by 1938, 23 states had permanent enactments. Reference, Table 1.1, p.3, John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*; Baltimore: Johns Hopkins University Press, 1983

7 Hawaii imposes a manufacturer's and wholesaler's tax at the rate of .5%. This tax applies to the sales of intermediate goods as they pass through the chain of commerce. Delaware and Washington also tax intermediate sales of tangible personal property. Indiana and West Virginia have taxed intermediate sales in the past but are in various stages of exempting these transactions. These taxes on wholesale and manufacturer have been addressed by John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*; Baltimore: Johns Hopkins University Press, 1983

Extension of Sales Taxes to Services -- General Considerations:

States make a number of distinctions in their sales, gross receipts or transaction taxes. Nowhere are these distinctions more apparent than in regard to taxing services. However, within the variety, there are a number of general and useful classifications. These classifications are generally related to the connection with tangible real or personal property. Other distinctions are made to reflect political or social policy goals. These services are listed in rough order of use in the various states, and correspondingly in rough order of connection with tangible property from taxation of selected tangible property at the top, through service connected with tangible or real property to pure professional service at the bottom:

1. Tangible personal property other than food and prescription drugs;
2. Food and prescription drugs;
3. Services delivered with tangible property (such as photofinishing, printing, photocopying, custom fabrication on customer owned property, custom computer programming, funeral services);
4. Services performed on tangible property (such as repair and installation, automobile towing, parking and storage);
5. Non-residential utility service;
6. Residential utility service (including inter- and intra-state telephone);
7. Cable TV services;
8. Amusements and admissions;
9. Transportation services (including taxis, bus & train, limousine and charter air flight services);
10. Construction of real property;
11. Repair and remodeling of real property;
12. Services performed on real property (including pest control, swimming pool cleaning, landscaping and lawn care);
13. Personal services (including barber & beauty shops, shoe repair, diaper service, tuxedo rental, laundry and drycleaning);
14. Business services (including security services, employment agencies);
15. Advertising, public relations and marketing; and
16. Professional services

Ohio, one of the median states, generally taxes categories 1,2,3,4 and partially 5. Oklahoma, the other median state, generally taxes categories 1,2,3,5,8 and 9. The other states tax none, some or all the categories.

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States tend to be incremental in their approach to taxation. It is very difficult for taxpayers and for the state tax agency to adapt to huge changes in the general tax philosophy. The most acceptable and likely form of increase in sales tax base, therefore, is a gradual expansion into a defined list of services. In many ways, this simply substitutes a new set of administrative and compliance problems and economic distortions for the old set, but the politics and administrability are more acceptable. It is a more contained debate, with a more defined set of opposing constituencies, to select a list of services and transactions to be taxed than to overturn several generations of common agreements. This is the "old tax -- good tax" argument.\(^\text{10}\) However, because this incremental approach is generated by political expediency, it is also fraught with the potential for idiosyncratic exemptions and deductions for certain powerful taxpayer groups. The result tends to be gerrymandering of tax policy, with accompanying administrative and compliance difficulties.

The alternative to the incremental or "laundry list" approach is the general taxation of all services with minimal exemptions to avoid double taxation, pyramiding or to achieve social policy goals (such as exempting health services or sales of services to non-profit organizations). This general approach has been achieved by New Mexico (1934), Hawaii (1935) and South Dakota (1969 & 1979). Delaware, West Virginia, and Washington also have general taxation of services under business and occupation tax statutes. The West Virginia system is rapidly becoming a unified sales tax with general taxation, and elaborate exemptions for business inputs.\(^\text{11}\) In the taxation of services, unlike taxation of tangibles, it is somewhat difficult to make valid distinctions between taxation under sales taxes and taxation under business and occupation statutes. The ultimate economic burden is shifted to capital, labor or consumption based on the same factors; the exemptions and deductions follow a similar pattern; and the administration and auditing principles are very similar.

**Taxation of Services -- Three Plausible Models:**

There are three viable models for discussion of sales taxation of services. In keeping with the discussion above, Model 1 extends the familiar sales tax on retail sales of tangible personal property to include a defined list of services. Practically, this extension occurs in three phases (the distinction is probably not temporal, but statistical). The first phase is the extension of the sales tax to the installation and repair of tangible property. The second is the inclusion of real property maintenance, repair and remodeling services, utilities, admission and amusements in the base, and the third phase is the inclusion of a list of certain other business or personal services. A typical example of a first phase state is Ohio (mentioned earlier as the median state), Kansas of a second phase state and Iowa of a third phase state.

The second services sales tax model, also discussed above, is that of a gross receipts tax imposed on virtually all services (and goods) unless specifically exempt. Since there are only three states (or six if

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\(^{10}\) For further discussion of the "good tax -- old tax" issue, see Laird Graesser, *Sales Taxation of Services: An Idea Whose Time Has Come?*; Revenue Administration, Proceedings of the Federation of Tax Administrators Annual Meeting (1990)

\(^{11}\) See *FTA Survey of Sales Taxation of Services*; op.cit.
Delaware, Washington and West Virginia -- which are primarily of the listed business and occupation type -- are included in this classification) with sales taxes of this type, further subclassification is not productive. However, these three states -- New Mexico, Hawaii and South Dakota differ substantially in the taxation of federal contractors, nonprofit organizations and intermediate goods and service providers. These technical differences compromise equivalent comparisons.

The final model is a theoretical construct -- a destination based, credit type value-added state consumption tax. This tax would be paid by every business in the state. The amount of the tax paid by each business is the tax rate times total sales less state VAT paid on purchases of goods and services. For reasons of uniformity and economic neutrality, it is further assumed capital goods (machinery, tools, computers, furniture and fixtures and transportation equipments, for example), whether purchased within or outside the state, are exempt from the tax. Michigan has a "Single Business Tax" that approximates this theoretical type of value-added state tax. However, in Michigan, the tax replaced the corporate income and franchise tax and is considered a business tax not a consumption tax. Michigan continues to impose and collect a retail tangible property tax. The comparison for the purpose of this paper will be against the theoretical tax model and not the Michigan version.

**Tax Policy Criteria:**

In judging tax systems and the tax program components, public finance economists are concerned with a number of criteria. Generally these criteria are equity, adequacy, neutrality, exportability and administrability among others.

**Horizontal Equity**

If two (household or business) taxpayers with the same level of permanent family income pay about the same amount of tax, the tax system exhibits horizontal equity. Similarly if these two taxpayers pay the same amount of income tax or the same sales tax, for instance, then these specified tax program exhibit horizontal equity. Under most (if not all) sales tax structures, two taxpayers, similarly situated with respect to income but with differing tastes for goods rather than services, or with differing tastes for taxed and non-taxed goods, will pay different amounts of sales tax to the state. Under some systems, the variability will depend on location of sale or production, whether goods or services are produced by a corporation or by a sole proprietor, or by transportation or energy factors. Thus, for example, rural taxpayers pay a different (usually greater) proportion of their income to the state as sales tax than do urban taxpayers.12

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12 In the example, it is likely that the rural taxpayer pays a lower fraction of income to the state as property tax. On balance, the rural and urban taxpayer may be paying about the same tax, and in any event, the differing taste for the calm and peace of the country may be worthwhile for rural taxpayers.
Although most public finance economists treat the sales tax as a tax on consumption for the purpose of analysis, the sales tax is imposed on both final consumers and businesses. The machines, the consumable supplies, the hand tools and the like purchased by businesses are subject to sales tax. The sales tax becomes a cost factor in the production of goods and services that themselves are taxed on sale. The extent of this taxation of intermediate sales has been estimated to range from 18% to 65% of the total tax yield.\(^{13}\) In the sense that taxation of intermediate goods and services causes misallocation of resources, the sales tax creates incentives to "overuse some inputs and underuse others."\(^{14}\) Figure 1 exhibits the links between businesses, households and the tax structure.

The current median sales tax (and all the other variants from no taxation to general taxation) is defective in regard to horizontal equity. A brief restatement is in order. Individual households with consumption preference for services generally pay less tax than households with identical permanent family income but a taste for goods. This frequently means that younger taxpayers, establishing their first household, pay a greater amount of tax than older taxpayers with taste for leisure activities and household services. In addition to horizontal inequity, there are implications for intergenerational inequities. Failure to tax repair ser-

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\(^{13}\) Raymond Ring Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*; National Tax Journal XLII (June 1989), 167-179. The consumer share calculated by Professor Ring vary from 82% in Massachusetts, 80% in Virginia to 37% in Hawaii and New Mexico and 35% in Wyoming. The average consumer share across the 45 states and the District of Columbia is 59%. The 18% to 65% numbers quoted in the text are the complementary business share when the consumer shares are 82% and 35% respectively.

\(^{14}\) Raymond Ring Jr., *Proportion*; op.cit., p 167.
vices distorts marginal decisions to purchase a new replacement product or repair the old one. Failure to tax construction services distorts the decisions to purchase or improve real property over the consumption of tangible personal property. Medical services, legal and other professional services tend to be overused because of the lower after-tax price. Energy conservation is inhibited by the failure to uniformly tax utility service. In states where telecommunications services are taxed but computer and information services are not, the development of new means of transferring information is distorted. Corporate investment in telecommunications research will tend to move toward the less taxed alternative. Again, these distortions are subtle but act as a drag on future economic growth. This type of lack of horizontal equity can be simply addressed by imposing uniform taxes on the services consumed at the same tax rate as that imposed on tangible personal property.

The other type of horizontal inequity, caused by taxing intermediate business purchases of services and goods is less amenable to solution. As mentioned, there is a great deal of pyramiding within the existing sales tax structure. Extending the sales tax to services is unlikely to improve this problem. These horizontal inequities increase approximately as the square of the tax rate. Thus a 4% sales tax rate is four times as distorting as a 2% rate. If the base expansion is coupled with rate reduction, it is likely that the overall equity will be improved. Unfortunately, states make major adjustments of the kind described when revenue is at issue. It is highly unlikely that "tax reform" provides sufficient motive to permit lowering rates while extending the taxable base.

One telling criticism of the taxation of business services is the potential of larger companies to "vertically integrate." For instance, a large company can afford to hire an in-house legal staff. The provision of legal services by employees is not taxed. If the company purchases the services of an outside lawyer on contract or retainer, then the services are taxed. Thus there is a reward for hiring the lawyer as an employee of the company and extending the range of activities of the company. Critics point to the fact that small businesses cannot afford to hire lawyers and accountants on staff and must purchase these services subject to tax. This, the argument goes, puts a burden on the most rapidly growing, dynamic segment of the economy -- the one that is providing the lion's share of new jobs. There are a number of unproved assumptions in these arguments. For example, the price elasticity of legal services is low, therefore a small increase in the price of a price inelastic service will have very small impact on the quantity of the service provided. Secondly, large companies purchase about the same relative amount of outside professional services as do small companies. The advantages and disadvantages of hiring specialists as opposed to employees do not alter significantly because of small increases in price. These counterarguments can be made technically, where the arguments themselves seem to be primarily emotional. There is, however, a substantial argument that contains significant truth and cannot be ignored.

15 Timothy E. Marx, Sales Taxation in the Service and Information Economy; 7 Hamline L. Rev. 19, 21-23 (1984)
There are significant differences in the impact on horizontal inequity of both types in the three models for extension of sales tax into the service arena. These differences will be discussed later. However, states have a great deal of scope to tailor the sales tax to improve horizontal equity by broadening the scope of the tax to include at least services consumed by households.

**Vertical equity (regressivity)**

The first and foremost criticism of sales taxes is that they are regressive. Higher income households or taxpayers pay a smaller proportion of their income than lower income households. The general assumption is that there are two principle rules of taxation: tax based on an ability to pay; and tax, insofar as possible, in relation to benefits received. The principle of vertical equity relates to ability to pay. Wealthier taxpayers have more discretionary income with which to pay taxes, therefore they should pay a greater proportion of their income as taxes. Generally, taxes based on consumption tend to be regressive, while taxes imposed on income (particularly if progressive rates are applied) tend to be proportional or progressive. One of the general services offered state residents is a political and economic climate conducive to the provision of goods and services in the marketplace. From this point of view, households that choose high levels of consumption of goods and services benefit from the orderly market provided by government choices and these consumers should pay higher tax for the privilege of participating. From the benefits received principle of taxation, consumption taxes have some validity.

One of the problems with regressivity is that no one quite agrees on the technical components, the time frame, the income construct or the appropriate family unit.\(^\text{16}\) Frequently, burden studies are published based on adjusted gross income of a taxpayer for a single year. Alternative choices are to focus on family rather than individual taxpayer, on family income (including transfer payments and non-taxable sources of income) rather than adjusted gross income, on permanent income (or lifetime incidence) rather than this year’s income. These choices are the subject of hearty debate in the professional literature.\(^\text{17}\) The general consensus is that family income and the family unit are the appropriate constructs. Thus, in families with more than one tax filer, the income should be aggregated before determining the income class to which the family belongs. Similarly, transfer payments and non-taxable sources of income should be included in in-


\(^{17}\) See for instance:

Roy D. Adams and David John Walker, *The Lifetime Incidence of Consumption Sales Taxes*; National Tax Journal, XXX, No. 4 (December, 1977), 463-466


Paul L. Menchik and David Martin, *The Incidence of a Lifetime Consumption Tax*; National Tax Journal, XXXV, No. 2 (June 1982), 189-203


come (but probably not capital income). Because of the difficulty in measuring "permanent income", annual actual money income should be used to determine income class. Similarly due to difficulty in measurement, rental value of owner occupied housing should be ignored as a source of income. An argument can be made for including the permanent income and rental value constructs in the determination of income class, however. The suggested exclusions are based not on theoretical purity but on difficulty of obtaining adequate data. The issue is particularly interesting in the case of wealthy renters versus homeowners with no house payments. The net resources after payment of housing expenses is vastly different, even if the income is the same. Attributing a rental value to the owned house would mean that the homeowner would be in a substantially higher income bracket than the owner for comparison purposes.

In this regard, the lifetime incidence of sales tax may be approximately proportional to lifetime income. Over a lifetime, individuals consume or save their lifetime income. (Figure 1 exhibits these linkages.) At death, accumulated wealth is distributed as bequests. If all consumption of goods and services were taxed at an equal rate, the only amount of lifetime income not subject to the sales tax is that amount distributed to heirs. Inheritance or estate taxes can be viewed, not as taxing lifetime net accumulated wealth, but as taxation of income received but not consumed. In this view, estate taxes are complementary to sales taxes, not income taxes. State taxation of bequests is highly progressive. Thus, subject to the proviso, the lifetime incidence of a comprehensive consumption tax is proportional to income (or slightly progressive).18 In the real world, the failure to tax services, and the imposition of tax on producer's goods invalidates the detailed agreement of the theory with practice. The conclusion, somewhat counterintuitively, is that states, in order to ensure vertical equity, must tax services consumed by households in the same fashion that they tax tangible personal property. From the standpoint of vertical equity, taxing a broad range of consumer services is indicated.

Even granting that by most measures of annual family income the sales tax is regressive, two further questions must be addressed: is a sales tax including services more or less regressive than a tax only on tangible property; and what adjustments can be made to address regressivity short of repealing the whole sales tax.

A number of economists have addressed these issues.19 The answers fall into three categories: first, some services are more regressive and some more progressive. For instance, coin operated laundry services are are consumed differentially much more by the poor than the wealthy, while recreation club fees, docking fees, private school tuition and foreign travel are more heavily consumed by the wealthy.20  

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18 Roy D. Adams and David John Walker, *The Lifetime Incidence of Consumption Sales Taxes*, op. cit


20 A computation and tabulation of the index of regressivity of various goods and services is contained in --Citizens for Tax Justice, *Nickles & Dimes*; (March, 1988). In addition see several of the articles enumerated in note 14, particularly the works by Judd and Schaefer.
adjustment in a general tax on services is to exempt certain services. The cost of this approach, however, may be too great on horizontal equity and efficiency grounds.

The second alternative that appeals to a number of states is to provide rebates, administered through the personal income tax system. At the cost of some administrative cost and effort, the rebates can be targeted based on family income, money income, family size, taxpayer age or any other economic, geographic or demographic characteristic appealing to the political process. The third solution is to adjust state benefit programs, such as welfare, medical indigency payments, job training or unemployment benefits to compensate for the sales taxes on lower income taxpayers.

**Intergenerational Equity:**

Little attention is paid to intergenerational issues. This is primarily for two reasons: consumers tend to experience similar lifetime circumstances; and measurement or administration of a tax policy involving more than one tax year is administratively difficult (or impossible). Life stages affect all citizens; the everyone has periods in life of dependency, purchase of goods to establish a household and provide for children, purchase of house, saving for retirement and retirement. Thus inequity among taxpayers at any one stage will be rendered equitable by compensating treatment in some other stage. The problem comes in that all taxpayers do not follow identical life paths and compensation is not as effective as immediate tax relief. One particular example is that not all consumers buy houses. Those that do provide different levels of tax revenue from those that don’t.

Older citizens tend to purchase relatively more services than goods, while younger citizens tend to the opposite. Thus the decision to tax services will have a more profound effect on the existing population of the elderly than the lifetime impact or the impact on the goods consuming generations.

It is difficult or impossible to measure these concepts, let alone design a tax policy that adapts to individual lifetime path variation. It must be enough to mention and debate the possible distortions and inequities.

**Efficiency (neutrality):**

Insofar as possible, a tax program or tax system should not force economic choices that are different than those made by rational consumers without a tax imposed. Different decisions forced by taxes cause the state economy to grow less rapidly; in extremis, a tax system can cause recession or depression. The specific mechanisms and impacts of this deadweight loss have been discussed earlier in this paper.

Unfortunately, many of the other perceived characteristics and requirements of the tax system are at direct odds with neutrality. Thus economic development or "social goals" such as access to medical or legal

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21 Seven states, Hawaii, Idaho, Kansas, New Mexico, North Carolina, South Dakota and Vermont provide rebates of some form. Various aspects of this approach are discussed by Bradford Case and Robert D. Ebel, *Using State Consumer Tax Credits for Achieving Equity*; National Tax Journal, XLII (September, 1989), 323-337
services, or home ownership, support for programs of not-for-profit organizations or reverence for personal labor tend to interfere with the blanket application of neutrality principle.

Neutrality is a somewhat technical and fuzzy concept to the non-economist. In the first place, any damage is done over time. There is little immediacy. Deadweight or welfare losses do not show up in immediate catastrophe. Deadweight losses are exactly that -- a drag on the long term performance of a state, regional or national economy. Making it even more difficult is that deadweight losses must be balanced against other desirable social goals achievable through the tax or economic systems.

An extension of sales taxes to services can improve or inhibit neutrality. For the median states and below, an expansion will undoubtedly result in a more neutral tax structure. However, states that choose to tax business services and other producer's goods will undoubtedly end up with a less neutral tax structure. With the possibilities ranging all over the map, the details of the proposal will control the extend of degradation or improvement in efficiency of each proposed structure.

**Adequacy and Stability:**
Politicians tend to like taxes that grow faster than the growth in personal income. Then tax collections will increase faster than inflation and provide revenue for program expansion without these expansions requiring new taxes or increases in tax rates. For instance, a 5% growth in income might stimulate a 7.5% growth in personal income taxes. Technically, this relation would be expressed as an income elasticity of 1.5. Sales taxes cannot be easily characterized by a single elasticity, since there are some goods and services components of any state's taxable base that will grow with income, and some that will decline with income. For instance, purchase of travel services is highly income elastic while automobile repairs have a low elasticity. Taxing travel services and exempting automobile repairs would tend to render the tax system more income elastic.

A number of researchers have investigated the elasticity and stability of tax revenues to variations in the components of the base. The general conclusion is that the selection of taxed goods and services can have significant or even profound impacts on the income elasticity and stability of tax revenues from the sales tax.

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22 See for instance:
Robert A. Bohm and Eleanor D. Craig, *Recent Sales Tax Trends: Services as a Point of Departure*; National Tax Association-Tax Institute of America, Proceedings of the 78th Annual Conference (1985), 54-62
William F. Fox and Charles Campbell, *Stability of the State Sales Tax Income Elasticity*; National Tax Journal XXXVII (June 1984), 201-212
Exportability and Interstate Competition:
The most basic principle of the politics of tax policy was enunciated by Senator Huey Long (D.,
Louisiana):

Don't tax you, don't tax me, tax the fella behind the tree.

In some minds, the "fella behind the tree" lives in another state. If my state can force your state residents
(and voters) to pay my state taxes, then my constituents get services provided at no direct cost to them-
selves. The manifest problems of this approach have led it be labeled the "beggar your neighbor" princi-
ple. The federal constitutional commerce and due process clauses limits to a great extent the amount of tax
exporting possible. What remains is still attractive politically. Export as much tax burden as possible.
However, what may happen in the process of designing taxes to be exported, is in-state businesses, which
provide jobs and leadership, are rendered less competitive in the national or international marketplace. Tax
exporting and economic development are frequently in opposition.

Imposing a tax on services consumed in the course of business production will result in more of the tax
being exported. The accounting or legal services, or janitorial and maintenance services consumed by a
manufacturer in the ordinary course of business are subject to a services tax. If the tax is passed forward
to consumers, then the price the consumers pay for the manufactured goods will increase and the tax is ef-
effectively exported to other states as price increases of exported goods. However, if the manufactured
goods are in direct competition with those from a manufacturer located in a state without the tax on pro-
ducer services, then the quantity of manufactured goods sold by the in-state manufacturer will be less,
profits will be lower, return on investment will be lower, wages will be lower. Whether the services tax is
exported or kept home depends on specific competitive circumstances which may vary within and between
industries and certainly between states.

At clear opposition to the desirability of exportability, is the desirability of economic development, plant
expansion and relocation. Generally, if state exports are taxed (through imposing taxes on intermediate
goods and services), then industries producing those goods and services are much less likely to relocate or
expand. This comment is not limited to sales taxes. States with high property taxes or high corporate in-
come taxes, will be significantly less able to compete in national markets and will chose to locate or expand
in states without the competitive disadvantages. This perhaps paints an overly simplistic picture. Expansion
and location decisions are conditioned on bottom line profitability projections. Cost of trans-
portation, cost of energy or labor, quality of labor, good labor relations and financing costs all exert signif-
ican pressure on bottom line profitability. It is difficult, if not impossible, to attribute an exact impact of
sales taxes or property taxes on location or expansion decisions.23

23 One empirical study (among many) is:
Michael Wasylenko and Therese McGuire, Jobs and Taxes: The Effect of Business Climate on State's Employment Growth Rates; National
Tax Journal XXXVIII (December, 1985), 497-511
The extent of exportability of a sales tax on services depends strongly on the degree to which intermediate services are taxed. The other primary mechanism of export is sales to tourists. However, consumer services delivered to tourists are in the realm of meals, lodging and amusements. These are already extensively subject to taxation in many states. Further capture of tax dollars from tourists may be quite limited.

In the wake of the Florida experience, there has been a great deal of debate over the impact of a tax on services on "footloose" industries. Some writers assume that service businesses are more footloose than manufacturing businesses. This may or may not be true, depending on industry type, services provided, fixed investment, licensing requirements and the like. Whether true or not that service businesses will move out of state, it is true that state tax policy must adapt to some changed principles to retain a level playing field. The impact of the tax must be such that in-state providers of service are not at a disadvantage relative to out-of-state providers. This must be true whether the service business is in competition for in-state or out-of-state sales. The issues of export of services, vendor imposition, and use tax on services will be discussed separately, later in this paper.

It should be mentioned in passing, that one former mechanism of export is no longer possible. Prior to the passage of the 1986 Federal Tax Reform Act, state sales taxes were deductible when computing federal (and state) personal income taxes. This meant that all federal taxpayers were subsidizing the cost of state sales taxes. Income tax payers in high income areas were subsidizing the sales tax payments in high sales tax jurisdictions.

Administrability:

A tax policy that causes problems for taxpayers or difficulties for the state tax agency is a tax policy that will fail. If taxpayers do not believe that the taxes are understandable, they will not think them fair. If the tax agency cannot audit to ensure accurate compliance, then voluntary compliance will vanish. If the costs of compliance are excessive, taxpayers will not comply. Tax law that relies on arbitrary or illogical distinctions forces extensive, time consuming and costly litigation. Administration and compliance go hand in hand. A tax that cannot be administered is a tax that has poor compliance.

To the extent that a sales tax on services removes distinctions among taxable activities, administration is improved. Four favorite examples are cited of somewhat bizarre or whimsical legislative or judicial interpretations of sales tax statutes: in Massachusetts, "hot nuts" are subject to the tax as restaurant food, while cold peanuts sold in markets are to be consumed at home and are exempt;24 small marshmallows sold in salads are taxable, but large marshmallows are exempt;25 pet grooming in Wisconsin is considered a tax-

24 Quoted by Richard Pomp in an address to the Federation of Tax Administrators, (June 1990)
25 United States Department of Agriculture, Food Stamp definitions. Food purchased with food stamps has been exempt from sales taxes since October, 1988.
able repair and maintenance expense applied to tangible personal property; and one of the most famous distinctions, pursuant to the Fingerhut case, is that a mailing list delivered on gummed labels is taxable whereas if delivered on non-perforated paper is non-taxable. These whimsical distinctions are generally won at the cost of burdening the judicial system. Forcing taxpayers and tax agencies to comply with illogical distinctions guarantees litigation, cost and disgruntled citizens. The equity, or economic development exemptions encapsulated in legislation always obscures bright lines that tax agencies and tax lawyers try to illuminate. Fortunately, extending the reach of sales taxes to include many services removes many illogical and arbitrary distinctions between taxable property and non-taxable services. In the extreme, there are no taxable distinctions between goods and services. Although there will always be tax protests and litigation, the courts become concerned more about jurisdictional interfaces and less with the interface between goods and services.

One popular criticism of extending the tax to services is the "administrative nightmare" of registering many new business entities and processing a vastly increased volume of tax returns. In rough terms, the number of businesses reporting to the tax agency will double. Proportional expenses such as collection and audit will also double, but automated tasks such as processing and posting will increase only slightly. Fixed storage costs will increase, but retention periods can be adjusted to account for the new volume of data. With the advent of automated filing and payment, these processing tasks will become cheaper and cheaper for both agency and taxpayer. These purely administrative problems can be addressed with an increase in appropriation to the tax agency commensurate with the increase in estimated revenue collection. There are certainly economies of scale that will be applied to the increase in administrative workload.

One further administrative impact has been predicted. Henry Thomassen, economist, professor and long time fiscal and revenue analyst in Georgia has speculated that the political viability of a broad base sales tax is conditioned on the support of the local cities and counties. Thus, a broad sales tax base may be accompanied by a proliferation of sales tax revenue sharing or of local option taxes. These complexities increase the administrative burden immensely. Further work on this premise is needed.

**Use Tax on Services:**

There is a large complex of issues surrounding the enactment of a tax on services loosely titled "level playing field". It is neither fair nor feasible to impose a tax on in-state service businesses while permitting services provided by vendors located outside state boundaries to deliver services in-state with no tax. This need for a level playing field involves discussions of compensating use tax on services, treatment of accounts receivable, the situs of services, vendor or consumer based imposition of tax and administration of the choices.

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Sales have two choices in determining the taxable event and site of services. The performance of the service can control the location and taxable event. Alternatively, the taxable event and location can be the delivery of and payment for the service. Consider the case of a rug shampooing service business. A company with headquarters location in state A (and city X) sends vans and work crews to clean rugs in state B (and city Y). State A can assert taxability based on commercial domicile and location of payment for services rendered. State B can assert taxability based on the location of performance of the service. Both states have nexus based on physical presence. Clearly, only one state can tax the service but which state? State B must insist on payment of sales tax or a use tax (with credit for sales taxes paid to state A) for this transaction, otherwise the out of state company will have a competitive advantage over companies resident in state B. State A might reasonably relinquish taxability based on the premises that the services are delivered out of state. Thus a delivery of service principle would result in rough justice provided all states adopted the principle.

Alternatively, State A, the producer state, could impose a sales tax, State B, the destination, market or recipient state, a use tax with credit for the sales tax paid to state A. This is similar to the agreement in place for sourcing service transactions for the purpose of corporate income tax under the Multi State Tax Commission agreements, as well as identical in spirit to the predominant treatment of out of state sales of tangible personal property. The producer state can assert taxability on tangible personal property delivered in the state. If the property is then exported to another state, a use tax is imposed in the destination state with credit offered against the sales tax paid in the producing state. Alternatively, if the goods are directly shipped out of state, the initial state might waive taxability of goods in interstate commerce. The use tax would still be due in the destination state, but no credit would be allowed, since no sales tax was paid. It is relatively important that the rules for sourcing and situs for corporate income tax purposes be as close to identical as possible to the same rules for sales and use tax purposes.

In the case of real property services or repair of tangible property, the performance location and taxable event are separated only by the accounting function of recognition of income and receipt of payment. The services are performed and delivered at the location of the real or tangible property. Or if the services are performed at another location, the use of the service is tied to the property.

A number of types of service transactions can occur: services performed in state and delivered with property out of state; pure services performed in state and delivered to an out of state purchaser; pure services performed in state for resale; services first used in state but performed by out of state firm with no nexus; services delivered to in-state businesses that are not incorporated in a final product. Each type of transaction should be taxable to some jurisdiction.

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27 Article 17 of the MTC agreement provides that sales will be wholly attributed to the state where the predominance of the service is performed based on the cost of performance. 19 states are full members of the MTC compact, with 12 more associate members.
It may well be that different situs and taxable event rules will be adopted based on the various types of transactions. For instance, in New Mexico, which has taxed services since 1934, the general rule on location is commercial domicile and the taxable event the recognition income for accounting purposes. The tax is imposed on the vendor, not the purchaser. However, services delivered out of state are exempt. The location of construction services is the building site, and the location of taxable telecommunications service is the location of the telephone instrument. Recently, New Mexico asserted taxability over research and development services performed out of the state but delivered for first use within the state. Thus four separate rules are operative for different types of service transactions. With some of the rules, performance location controls with commercial domicile the surrogate for performance location. With others, use location controls. To further confuse the issue, except for no use tax is imposed on services (other than research and development services) performed out of the state but first used in state.

In the landmark Florida services tax legislation of 1987, the general rule on situs of services was the location of the associated real or tangible personal property. Special apportionment rules were written for sales of advertising or repair services in interstate commerce. For pure services, the general principle seemed to be to attribute the use to a market area. In general, Florida attempted to adhere to a location of use principle. A use tax was imposed on services performed outside the state but used in Florida.

It is not at all certain what is the preferred method of ensuring a level playing field. What may be the fairest or the most politically feasible structure may have compliance and administrative difficulties. The bright lines must be very bright to render these ideas possible. It may very well be, that the level playing field is an ideal that cannot be accomplished within an feasible administrative structure.

One path to statutory and political simplification to this admitted mess, is to impose the sales and compensating use tax on the vendor and not the consumer. States with consumer impositions treat the vendor as a fiduciary agent. This fiduciary agency is not highly compatible with an imposition of a use tax on services, since the business is the user. This assumes that it is not practical to collect a use tax on services from households. Thus the only feasible collection targets are in-state businesses delivering services in-state, out-of-state vendors delivering services in state and with sufficient nexus to impose the tax, or in-state businesses using services in-state as final consumers. The imposition on the vendor relieves states of the necessity of paying commissions for collection of tax to vendors. Of course, vendors should be permitted to pass through the tax to the consumer, without having to pay tax on tax. Lien and levy action and other compliance and cross check activities of state tax departments are rendered in a somewhat more straightforward manner with the vendor imposition.

One interesting possibility arises in the case of the vendor imposition. At the cost of imposing a tax on state service contractors, federal service providers can be taxed. The tax will be passed through from the vendor to federal taxpayers. This approach is used most extensively in New Mexico pursuant to a land-
mark case\textsuperscript{28} decided by the Federal Supreme Court in 1983. Although the federal government could possibly pass legislation to prevent this taxation and subsequent passthrough, current interpretation permits states indirectly to tax the federal treasury.

\textbf{Other Considerations:}
Tax policy deliberations are buffeted by pressures to recognize various goals beside the primary need to collect revenue. Some of these goals have been discussed as equity, exportability, adequacy, administrability, etc. However, the classic public economics criteria are only a portion of the considerations in the political arena. Economic development and social policy exemption arguments exert pressure to relieve tax burden for worthy and notable reasons.

At any point in time, the legal community, the home builders, the not-for-profit charities, the doctors and hospitals, the business community, manufacturers, small businesses, banks and insurance companies, taxpayers associations and many other constituent groups offer logical, compelling evidence that a particular form of tax is particularly burdensome to that group. They may be quite correct. In addition to acknowledging this correctness, the political process must adapt tax policy to conform to the accepted principles and criteria of good tax policy, while minimizing the adverse effects on particular constituent groups. Fortunately, there is almost always an acceptable compromise.

\textbf{Rating the Models Against the Criteria:}

The three prototype models of sales tax on services are: selected list of business and personal services; general taxation of all services; and state value added tax. These three models will then be compared against the criteria discussed.

\footnote{\textsuperscript{28} Originally cited as United States v. State of New Mexico, 581 F.2d 803, 10th Cir. 1978. Became known as the ERDA case on review by Federal Supreme Court. Further reference may be obtained on application of the New Mexico Taxation and Revenue Department, Legal Office.}
<table>
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<tr>
<th>Comparing Models Against Criteria</th>
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<tr>
<td><strong>Selected List of Business and Personal Services.</strong></td>
<td><strong>General Taxation of Services</strong></td>
<td><strong>State Value Added Tax</strong></td>
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<tr>
<td><strong>Horizontal Equity</strong></td>
<td>For states currently below the median, virtually any expansion will improve horizontal equity. States that choose to tax business services will have mixed impact. To the extent that repair and installation, utility, amusements and transportation services delivered to households are taxed, horizontal equity will be improved. Some services such as private schools, foreign travel and domestic service will be free of tax and will render further horizontal inequities.</td>
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<tr>
<td><strong>Vertical Equity</strong></td>
<td>Vertical equity is likely to improve for many states. Inclusions of utility services and some personal services will render the tax more regressive; repair, real property construction, amusements and transportation services will make the tax less regressive. Taxation of business services will have variable equity impacts, generally unfavorable since price increases caused by taxation of business inputs are borne differentially more by the poorer taxpayers. The broader the list of personal services and services delivered to households, the more progressive the tax becomes. Vertical equity will improve for most states. Inclusions of utility services and some personal services will render the tax more regressive; repair, real property construction, amusements and transportation services will make the tax less regressive. The fewer the exemptions, the more progressive the tax. Taxation of business services will have variable equity impacts, generally unfavorable since price increases caused by taxation of business inputs are borne differentially more by the poorer taxpayers. Vertical equity will improve for all states. Inclusions of utility services and some personal services will render the tax more regressive; repair, real property construction, amusements and transportation services will make the tax less regressive. The fewer the exemptions, the more progressive the tax. Taxation of business inputs is avoided by a VAT, hence equity effects caused by taxation of producer's goods are avoided. Resulting tax is still regressive and rebates should be considered.</td>
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<tr>
<td><strong>Adequacy and Stability</strong></td>
<td>Tax on personal services will raise moderate revenue; tax on business services will raise significant revenue. The broader capture of all consumption the more stable the revenue. Some exemptions will promote stability, some exemptions will result in instability or procyclical revenue collections.</td>
<td>Tax on very broad base will raise substantial revenue. Doubling current sales tax yield is possible. The broader the base of consumption and intermediated services, the more stable the revenue. Some exemptions will promote stability, some exemptions will result in instability or procyclical revenue collections.</td>
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<tr>
<td>Efficiency (neutrality)</td>
<td>Current impositions cause significant welfare loss. Extending tax to services consumed by households will improve neutrality. To the extent that the expanded base includes business services, a welfare loss of the second kind results. Overall, for most current structures, a list approach will result in improved efficiency.</td>
<td>Extending tax to services consumed by households will improve neutrality. To the extent that the expanded base includes business services, a welfare loss of the second kind results. Overall, for most current structures, a gross receipts approach will result in substitution of one type of inefficiency for another. Overall, the details of which services are exempted will control the overall improvement or degradation of efficiency.</td>
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<td>Exportability</td>
<td>Tax on tourist services (meals, lodging, tourist attractions) will be exported. Portion of tax on business services will be exported as increase in price of goods. By and large, tax on household services will be borne by residents.</td>
<td>Tax on tourist services (meals, lodging, tourist attractions) will be exported. Portion of tax on business services will be exported as increase in price of goods. By and large, tax on household services will be borne by residents. Export as increase in price of goods will depend on manufacturing base in state.</td>
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<tr>
<td>Administrability</td>
<td>Expansion will increase difficulty in drawing &quot;bright lines&quot;. Arbitrary and capricious choices will interfere with compliance and administration. Significant resources will be siphoned into the legal and legislative definition of taxed services.</td>
<td>Presumption of taxability improves compliance and administration. Only for specific circumstances or transactions, easily documentable, will deductions or exemptions be granted. Auditing consists of verifying the documentation of exemptions and deductions.</td>
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<tr>
<td>Other Considerations</td>
<td>Compatible with use tax on services, provided clear situs and sourcing rules adopted. Vendor based imposition and location of performance test of situs most administrable. Tax on federal contractors possible.</td>
<td>Compatible with use tax on services, provided clear situs and sourcing rules adopted. Vendor based imposition and location of performance test of situs most administrable. Raises possibility of indirect taxation of federal treasury.</td>
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