Expanding Sales Taxation of Services: Options and Issues

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CENTER ON BUDGET AND POLICY PRIORITIES

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Summary

Sales of tangible goods dominate most states' sales tax bases; only a few states impose their sales taxes on a broad array of services. Sales of "non-durable goods" like clothing and light bulbs and "durable goods" like cars and computers generate the vast majority of state sales tax receipts. According to the Federation of Tax Administrators, a majority of states apply their sales tax to less than one-third of 164 potentially-taxable service categories. Eight of the 45 states with sales taxes impose them on fewer than 20 service categories.[1]

Most states could improve their sales taxes and their tax systems in general with some expansion of the tax base to include services. Adding services could make tax systems fairer, more stable, more economically neutral, and easier to administer. Perhaps most importantly in the current fiscal crisis, adding services to a state's sales tax base could help close fiscal gaps and avert cuts in important services or other, less sound, tax increases. There are significant economic, administrative, and legal issues that must be addressed in expanding sales taxation of services. The barriers are not insurmountable, however, and the benefits from a broader sales tax base outweigh the challenges.

Why Tax Services?

Public finance economists and other tax experts have been urging states for decades to include more services in the sales tax base.[2] Taxing services meets all of the criteria by which state tax policy options are normally evaluated.

- **Taxing additional services can generate substantial new sales tax revenue**. Table 1 (see page 5 in the body of the report) indicates that the annual, nationwide revenue yield from taxing all services purchased by households except health care, education, housing, and a few others would be on the order of $57 billion. The *new* revenue from taxing household services would be less than this, since most states do tax services to some extent. Table 1 suggests, however, that states that do not tax services to any significant degree at present — such as California, Illinois, Michigan, and Virginia — probably could increase their sales tax revenue

Sales and Use Taxes: An Introduction

Most people are familiar with the sales tax, the charge that is added to the cost of goods and some services purchased in retail stores. The tax is calculated as a percentage of the sales price, collected from the purchaser at the time of sale, and remitted weekly or monthly by the retailer to the state tax agency.

How much revenue is generated by the sales tax depends on both the percentage tax rate and the "tax base" — the goods and services that are subject to taxation. Besides omitting most services from the tax base, many states exempt from taxation categories of goods viewed as necessities of life, such as food and medicine.

In addition to taxing goods and a few services purchased by households at retail stores, sales taxes often apply to purchases by businesses from other businesses. A retailer's purchases from a manufacturer or wholesaler of items for resale usually are not subject to sales taxation, nor are a manufacturer's purchases of items that are directly incorporated into its output. Nonetheless, goods and services purchased by businesses that do not fall into either of these categories — such as manufacturing equipment, electricity, and office furniture — are often subject to sales taxation. The policy issues raised by the taxation of such "business-to-business" sales will be discussed at length in the body of this report.

Sales taxes are charged when the seller and buyer are in the same state. States levy "compensating use taxes" on purchases of goods when the seller and buyer are in different states. The use tax is almost always identical to the sales tax with respect to both rate and base. The purpose of the use tax is to eliminate the possibility of avoiding sales tax by purchasing from an out-of-state vendor — and thereby eliminate the incentive to do so. In some cases, the out-of-state seller charges the use tax to the buyer just as if the tax were a sales tax, and the buyer is unaware of the distinction. Even if the seller does not charge the use tax, the buyer is legally obligated to pay the use tax directly to the state in which the purchase will be used. (This obligation is largely ignored by individual consumers but frequently fulfilled by businesses that buy from out-of-state vendors). Use taxes are imposed only rarely on interstate purchases of services; as will be discussed elsewhere in this report, one consequence of expanding sales taxation of services may be a need to reconsider that policy.

Some states levy special taxes on particular services in lieu of or in addition to the sales tax. For example, some states impose special taxes on car and hotel rentals, admission charges for entertainment and cultural events, and utility services like telephone and electricity. Where such taxes are not imposed in lieu of some other business tax (such as the corporate income tax), and where they legally may be passed on to purchasers like the sales tax through itemization on the bill or invoice, these special taxes may be thought of as sales taxes for purposes of much of the analysis contained in this report.

The District of Columbia and forty-five states — all except Alaska, Delaware, Montana, New Hampshire, and Oregon — levy sales taxes. They are a critical revenue source for state governments, supplying $179 billion in state tax revenue in 2002 — 35 percent of total state taxes. In many states, local governments also levy sales taxes.

by 25 to 30 percent if they taxed services purchased by households comprehensively.

Some states have prepared their own estimates of the revenue that could be gained by expanding the sales taxation of services. Texas estimates that broadening its sales tax to include just five types of services could yield on the order of $600 million in additional sales tax receipts annually. Michigan estimates that its failure to tax services costs the state $4.8 billion each year.[3]

- **Taxing services broadly is essential if the long-run revenue adequacy of the sales tax is to be maintained**. Household spending has been shifting from goods to services for decades. The traditional sales tax base, purchases of durable goods plus non-durable goods except groceries (which the majority of states exempt), fell from 39 percent of household consumption in 1970 to 33 percent in 2001. Over the same interval, consumption of services rose from 31 percent to 44 percent of total household purchases.[4] Largely to compensate for this trend, states have increased sales tax rates sharply over the last 30 years. The ability of states to continue raising rates is constrained, however, by such factors as the ease with which consumers can shift their purchases to the Internet — where sales taxes often are not charged. Assuming that consumption will continue to shift toward services, including services in the tax base therefore will be essential to maintaining sales tax revenues over the long term.

- **Bringing services into the sales tax base may reduce the year-to-year volatility of sales tax collections**. Sales tax bases are dominated by purchases of "big-ticket" durable goods (such as cars, appliances, and furniture), which often decline sharply during economic downturns. Limited research finds that purchases of some services do not fall as precipitously as durable goods purchases do when the economy slows nor rise as rapidly when the economy is booming. The research suggests that including more services in the sales tax base could moderate slightly the volatility of sales tax revenues over the course of the business cycle.

- **Expanding the taxation of services will make the sales tax fairer**. The sales tax is intended to be a general tax on consumption. There is little reason to distinguish between consumption of goods and consumption of services, which in fact can be substitutes for one another. For example, it is not equitable — it violates the principle of "horizontal equity" — to tax the person who rents a videotape but not the person who watches a pay-per-view movie on cable TV.

  Moreover, sales taxes are regressive; that is, they absorb a larger proportion of the income of lower-income taxpayers than of higher-income taxpayers. In part, this is because higher-income persons do not consume their entire incomes; the portion of their incomes that they save is not subject to sales or other consumption taxes. Ideally, one could consider reducing the regressivity of sales taxes by expanding the sales tax to services purchased primarily by the affluent. While worth doing, the revenue gain from expanding the sales tax solely to services purchased by the affluent is not substantial. To broadly tax services, one must include services purchased by low-, moderate- and middle-income households as well as those purchased by high-income people. In general, a broad expansion of sales taxation to services will not change relative tax burdens.[5]

There is one circumstance, however, in which expansion of the sales tax to services could make a state's overall tax system somewhat less equitable. That can occur if taxing services raises the proportion of total state revenue that is derived from the sales tax and thereby lowers the proportion that is derived from more progressive sources such as personal and corporate income taxes. There are a number of ways this potential to increase the regressivity of the tax system as a whole can be avoided. The sales tax base expansion can be balanced with other changes in the tax code, such as an increase in the personal income tax. Alternatively, targeted credits administered through the income tax or rebates of sales taxes paid can be used to mitigate the increased sales tax burden low-income families could experience when a sales tax is broadly expanded to include services.

- **Taxing services can improve the allocation of economic resources**. The failure to tax services while most goods are taxed subtly distorts resource allocation throughout the economy by creating an artificial incentive to purchase services rather than goods. For example, some consumers may be encouraged to repair older cars and appliances rather than replace them with more energy-efficient and less polluting alternatives — although the effect is probably modest. The failure to tax services has also contributed to steady increases in sales tax rates, which create their own economic distortions. Unnecessarily high tax rates on goods resulting from under-taxation of services stimulate such wasteful activities as tax-motivated interstate shopping.

- **Expanding the taxation of services can simplify the process of administering and complying with the sales tax**. Expanding the taxation of services can reduce the effort and costs entailed in enforcing and complying with the sales tax. When retailers sell taxable goods and services as well as tax-exempt services, it can be difficult and costly for tax administrators and merchants alike to ensure that the proper amount of tax has been collected and remitted. If all of a retailer's sales are subject to tax, many accounting burdens and disputes diminish or disappear.

Expanded taxation of services can contribute to the realization of all of these arguably desirable tax policy objectives. There are tradeoffs involved, however. For example, moving toward comprehensive taxation of services could strain the administrative capabilities of state tax departments if done too quickly, since many businesses that previously did not collect sales tax would need to be brought into the sales tax system. Thus, achieving an optimal balancing of these goals requires an understanding of all of the potential effects of expanding taxation of services and careful choices about which services to tax.

Which Services *Could* States Tax? Which Services *Should* They Tax?

As policymakers contemplate which currently-exempt services to begin taxing, it can be useful to think of services as falling into three categories:

- services primarily purchased by businesses, such as payroll processing and television advertising,

- services primarily purchased by households, such as diaper service and cable TV, and

- services frequently purchased by both households and businesses, such as landscaping and pest control.

Economists generally counsel states to forego taxing the first category of services, so-called "business-to-business" sales. They point out that taxing the goods and services businesses buy to use as inputs into the production of other goods and services often leads to "tax pyramiding." Tax pyramiding refers to the situation in which an input is taxed when purchased and then effectively taxed again when its cost is passed through into the price of a taxable good or service into which it has been incorporated. Tax pyramiding results in the actual sales tax imposed on a particular good or service bought by a household being higher than what is added at the cash register. Because the sales taxes imposed on inputs are hidden in the selling price of the item, states may tend to rely on this revenue source more than they otherwise would. Moreover, some research suggests that the hidden sales taxes are even more burdensome for low-income families than the visible sales tax that is imposed on the final sale, because necessities like food and utilities that often are tax-exempt nonetheless can have substantial sales taxes hidden in their prices.

Taxation of business inputs also tends to complicate sales tax administration. For example, rules need to be developed for taxing services like accounting that are purchased by businesses for company-wide use in multiple states.

The greatest concern of economists regarding sales taxation of services purchased by businesses is that it can distort the allocation of economic resources. Since services provided to an employer by an employee are rarely subject to sales tax, taxation of business-to-business sales of services can encourage businesses to provide services using their own employees even if they could be produced more efficiently by an independent firm. In addition, if purchases of services subject to sales tax are major cost items for a business (for example, electricity and telecommunications services for an Internet service provider), a more efficient business that tries to pass those taxes into its prices could lose business to a less efficient competitor located in another state that exempts those inputs from sales taxation. Alternatively, a business that makes substantial purchases of taxable services might choose to expand in a state that is sub-optimal from an economic efficiency standpoint but that exempts those services from sales tax.

While these arguments against taxing business purchases of services have merit, there are at least two countervailing considerations:

- State sales taxes already apply to numerous purchases of *goods* by businesses. Assuming that the concerns of economists about the distorting effect on resource allocation of taxing business inputs are valid, economic theory implies that the distortion grows as the tax rate increases. If the choice is between increasing the tax rate at which business-to-business sales of goods are taxed and taxing some business-to-business sales of services in order to hold down the tax rate, the latter could be preferable from an efficient allocation of resources standpoint.

- In an economy in which a growing number of people run their own businesses, exempting all purchases of goods and services by businesses would open the door to substantial tax evasion. Business owners could claim purchases of many services — such as telecommunications, hotel rentals, and auto and computer repair — to be for business use when they were actually for personal use. Preventing this abuse would require that substantial additional resources for tax enforcement be provided to state tax departments. The costs of preventing tax evasion could exceed the economic benefits of exempting business inputs from taxation.

In broadening their states' taxation of services, policymakers generally have struck what arguably is a reasonable balance among the resource allocation issues raised by economists, their states' revenue needs, and practical tax enforcement considerations. States largely have avoided taxing services purchased almost exclusively by businesses (like advertising and accounting); instead, to the extent they have taxed services, states have targeted household services (like haircuts) or mixed household/business services (like landscaping). Where a particular industry has made a credible case that taxation of a service in the latter category has an adverse economic impact (for example, telecommunications purchased by financial institutions), elected officials also have been willing to enact industry-specific exemptions. Such an approach may make more sense than an across-the-board exemption for all services that happen to be purchased by businesses as well as households.

Even if states forego taxing services that are predominantly purchased by businesses, there is a vast array of household services to which the sales tax can be applied. Appendix I of this report lists over 200 types of services purchased by households or by both households and businesses, organized into 20 broad categories including personal care, home cleaning and maintenance, recreation and travel, and lawn and garden. As entrepreneurs perceive new profit-making opportunities, new services will continue to be invented. States can either implement taxation of services in a way that will incorporate newly emerging services or can monitor the evolution of the service sector and update their tax policies accordingly.

The Legal Mechanics of Broadening the Sales Taxation of Services

Legislators can expand the taxation of services in two different ways. The comprehensive approach is to apply to services the typical language used to tax goods. Under most state sales tax laws, all sales of goods are taxable unless they are explicitly identified as exempt. Hawaii, New Mexico, and South Dakota apply this same treatment to sales of services.

Hawaii and New Mexico adopted this approach from the inception of their sales taxes; South Dakota did so to expand the taxation of services well after the sales tax had been enacted.

The remaining states that tax services do so by specifically enumerating taxable services. The enumeration often can be found in the definition of a "retail sale."

Each approach to taxing services has its own advantages and disadvantages. A key advantage of the comprehensive approach, for example, is that newly-developed services are immediately taxable without legislative action. This is appropriate given the role of the sales tax as a general tax on consumption. It also ensures that the revenue yield of the sales tax is maintained as new services displace old ones (for example, as Internet e-mail service substitutes for faxing as a means of transmitting documents).

The major disadvantage of the comprehensive approach to expanding the sales taxation of services is that it is likely to bring a large number of services into the sales tax base in one fell swoop. The services subjected to taxation are likely to include many business-to-business services that policymakers might not wish to tax because of the potentially adverse economic effects discussed previously. Moreover, state revenue departments may not be equipped to integrate numerous new services and the merchants selling them into their sales tax administration systems in a short period of time. These factors likely explain why of all the states that have expanded their taxation of services over the years, only South Dakota did so comprehensively.

The greatest challenge facing legislators who choose to extend their state's sales tax to specifically-enumerated services is defining unambiguously the services they intend to tax. Many services are technologically complex and industry-specific, and legislators and their staffs cannot be expected to be business experts. Clear definitions are essential, however, because providers of a newly-taxed service often will look for every legal opportunity to avoid having to add a 4-10 percent sales tax to their prices. In a current case, for example, America Online is disputing Tennessee's claim that its Internet access service falls under the state's definition of taxable telecommunications.

A question often arises as to whether it is preferable to write the law to identify taxable services in broad terms (such as "fees for participant sports") or specifically (such as "admissions, equipment rental, and other fees for bowling, batting cages, skiing. . ."). The answer is that states would be well-advised to do both. ("Taxable sales include admission, equipment rental, and other fees for participant sports, which include but are not limited to bowling, batting cages, skiing . . .") Broad definitions can serve as a good "backstop" for more specific listings that may inadvertently omit a particular service. A broad definition can also provide a basis for taxing a newly-invented service until such time as the legislature has an opportunity to identify it explicitly. Nonetheless, broad definitions are not sufficient to ensure taxability in the face of a taxpayer determined not to charge sales tax.

One promising approach to enumerating taxable services is to piggyback on standardized lists and definitions developed for other purposes. The North American Industry Classification System (successor to the well-known SIC system) and the North American Product

Classification System (under development) could be referenced for sales taxation purposes.[6] South Dakota's sales tax statute already references SIC definitions, for example. In addition to taking advantage of careful definitional work, using NAICs or NAPCS to establish the state sales tax base could make it easier to gauge the revenue impact of taxing services; state-by-state data on the dollar volume of sales of services are already categorized by NAICS and will be further categorized by NAPCS when it is completed.

I. Why Tax Services?

Sales of tangible goods dominate most states' sales tax bases; only a few states impose their sales taxes on a broad array of services. Sales of "non-durable goods" like clothing and light bulbs and "durable goods" like cars and computers generate the vast majority of state sales tax receipts. According to the Federation of Tax Administrators, a majority of states apply their sales tax to less than one-third of 164 potentially-taxable service categories. Eight of the 45 states with sales taxes impose them on fewer than 20 service categories.

The fact that most services are excluded from the sales tax base is largely an artifact of the historical circumstances in which sales taxes were first imposed. Mississippi enacted the first sales tax in 1930 as the Great Depression was beginning; 23 other states had enacted sales taxes by the outbreak of World War II. States needed their new sales taxes to generate substantial revenues quickly, in order to replace plummeting property tax receipts that had been the mainstay of their treasuries. Given this overarching goal, focusing the tax on the sale of goods made sense for several reasons. First, goods were easy to describe and identify; indeed, most states simply wrote their laws to say that all sales of "tangible personal property" were subject to sales tax unless explicitly exempted. (The distinction between "real property" — real estate — and "tangible personal property" — moveable goods — was already well-established in property tax law.) Second, focusing the sales tax on goods helped to maximize revenues by minimizing the potential for tax evasion. The tendency of goods to be sold, shipped, and resold several times between manufacture and final consumption created a paper trail that could be used by public officials charged with enforcing the sales tax.[7] Finally, the production and sale of goods dominated the economy of the 1930s; services averaged only about two-fifths of personal consumption expenditures during that decade. Focusing the tax on goods thus yielded the biggest revenue "bang" for the tax administration "buck."[8]

Of course, the economy of today is vastly different from that of the 1930s. In 1982, household consumption of services (including housing) exceeded household consumption of goods for the first time.[9] In 2001, household purchases of services represented 58.8 percent of personal consumption expenditures; the trend is likely to continue slowly but steadily upward. The growing importance of services in the economy has encouraged some states to broaden their sales tax base to include more services, particularly at times of fiscal distress. Nonetheless, sales taxation of services remains quite limited in most states.

Public finance economists and other tax experts have been urging states for decades to include more services in the sales tax base. Taxing services meets all of the criteria by which state tax policy options are normally evaluated.

- Taxing services can generate substantial new sales tax revenue.
- Taxing services broadly is essential if the long-run revenue adequacy of the sales tax is to be maintained.
- Bringing services into the sales tax base may reduce the year-to-year volatility of sales tax collections.
- Expanding the taxation of services will make the sales tax fairer.
- Taxing services can improve the allocation of economic resources.
- Expanding the taxation of services can simplify the process of administering and complying with the sales tax.

Expanded taxation of services can contribute to the realization of all of these arguably desirable tax policy objectives. There are tradeoffs involved, however. For example, moving toward comprehensive taxation of services could strain the administrative capabilities of state tax departments if done too quickly, since many businesses that previously did not collect sales tax would need to be brought into the sales tax system. Thus, achieving an optimal balancing of these goals requires an understanding of all of the potential effects of expanding taxation of services and careful choices about which services to tax.

The Short-term Revenue-raising Potential of Expanding the Taxation of Services

In the near term, revenue considerations are likely to drive the discussion in most states about whether to subject additional services to the sales tax. Most states are in severe fiscal straits and are likely to remain so until the economy and the stock market bounce back from their current difficulties. Public officials are looking for tax policy changes that can raise additional revenues quickly. Broadening the base of all taxes, including the sales tax, may be a particularly attractive revenue-raising mechanism. Base-broadening often affects a limited number of taxpayers, and it sometimes reasonably can be characterized as closing unfair tax “loopholes” rather than as an across-the-board tax increase.

The amount of revenue a state will gain by extending its sales tax to sales of additional services depends on four factors:

- which specific services are selected for taxation,
- the volume of sales of those services occurring within the state,

- the extent to which the volume of sales is dampened by the effective increase in price that occurs when sales tax is added to the existing retail price of the services, and

- the extent to which sellers or purchasers are able to avoid or evade the tax.[10]

While these factors seem straightforward, it is difficult in practice to generate a precise estimate of how much sales tax revenue could be gained in a particular state by extending the sales tax to additional services. The federal government does collect (as part of its economic census) state-by-state data on sales of services, broken down by fairly detailed service categories.[11] Multiplying these sales figures by the state sales tax rate yields a good first approximation of the revenue that would be generated by taxing the service. Unfortunately, the most recent such data are from 1997, and so adjustments need to be made for both inflation and real growth in sales since that time. Moreover, the sales data are published separately and somewhat differently for firms with employees and those operated by sole proprietors; these two data sets must be merged. Further adjustments are needed to avoid double counting as sales of services what are actually sales of taxed goods by service businesses (for example, sales of auto parts by auto repair shops). While none of these issues constitute insurmountable problems, generating state-by-state revenue estimates based on these state-specific Census Bureau data would be extremely labor-intensive and is beyond the scope of this report.

Estimating the Revenue Yield from Taxation of Services Using Nationwide Data

A different set of federal government statistics can be used to generate a rough, "order-of-magnitude" estimate of the revenue potential of comprehensive state sales taxation of services purchased by households. The "Gross Domestic Product" (GDP) accounts of the United States published by the Commerce Department include a reasonably detailed breakdown of household purchases of services; these have the advantage of being published each quarter and calculated in such a way that sales of goods by service businesses are not inappropriately counted as sales of services.

Table 1 develops a state-by-state estimate of the potential sales tax revenue that would be generated by comprehensive state sales taxation of services purchased by households. The estimate assumes that states would tax all household purchases of services other than health care, housing, education, legal, banking, public transit, insurance, and funeral services. For distributional, practical, and/or political reasons, it seems unlikely that policymakers in many states will seek to extend their states' sales taxes to these categories of services.[12] The remaining potentially-taxable services are labeled "readily-taxable services" in Table 1.

The major shortcoming of using the GDP data on household consumption of services to generate a sales tax revenue estimate is that the data are only available for the entire United States. Thus, the estimates in Table 1 are based on the assumption that sales of particular services in a state are proportional to the size of the state's economy — as measured by the state's share of national personal income reported by the Commerce Department.[13] The first column of Table 1 reports the share of national personal income realized by residents of each state. Column 2 takes $1.148 trillion in 2001 nationwide purchases of readily-taxable services from the GDP accounts and apportions it to each state in proportion to that state's share of national personal income. Column 4 calculates the revenue that would have been generated in Fiscal Year 2001 by fully taxing the readily-taxable services, by multiplying the state sales tax rate in effect on July 1, 2001 (column 3) by the amount in column 2. Column 5 reports actual state sales tax collections in 2001.[14] Finally, column 6 calculates the revenue yield from full taxation of readily-taxable services as a share of actual sales tax collections in that year (column 4 divided by column 5).

Table 1 indicates that:

- Full taxation of "readily-taxable" services could generate sales tax revenue equal to 25-35 percent of current sales tax collections in about three-fourths of the 45 states currently levying a sales tax.

- The total revenue yield nationally would be approximately $57 billion per year.

- The annual revenue yield in specific states ranges from more than $8 billion in California to just $77 million in Wyoming.

Of course, most states already tax some household services, and so it would be unreasonable to expect their revenues to *increase* by the percentages shown in column 6 of Table 1. Table 2 shows which states tax 40 services purchased predominantly by households, selected from the Federation of Tax Administrators 1997 survey cited above.[15] Downward adjustments need to be made to the figures in column 6 of Table 1 to take into account existing taxation of services before those figures can be used to gauge the potential *gain* in revenue from broadening the sales tax base.

In addition, if the effective price of services rose by anywhere from four to ten percent due to the imposition of a sales tax, sales of services — and hence the revenue yield — likely would drop as well initially due to the normal inverse relationship between price and consumer demand. It is also reasonable to expect that there would be a certain amount of non-compliance by certain service providers even if they were legally required to charge sales tax — for example, by individuals providing services in peoples' homes on an informal basis.

Even after making downward adjustments for these factors, however, Table 1 suggests that many states could reasonably expect to realize 25-30 percent increases in sales tax revenues if they extended their sales taxes to all "readily-taxable" services. In particular, states like California, Colorado, Illinois, Massachusetts, Michigan, and Virginia, which tax virtually no services currently, could gain substantial amounts of revenue.

Table 1
Estimated Sales Tax Revenue Yield from Taxing All "Readily-Taxable"* Services
($ millions)

	Share of 2001 Ntl. Personal Income	Estimated Purchases of "Readily-taxable" Services	July 1 2001 Sales Tax Rate	Revenue from Taxing Services	FY01 State General Sales Tax Revenue	Revenue from Services as Percent of Current Revenue
	(1)	(2)	(3)	(4)	(5)	(6)
United States	100.00%	1,148,000	5.000%	57,400	184,315	31%
Alabama	1.26%	14,522	4.000%	581	1,823	32%
Arizona	1.58%	18,164	5.600%	1,017	3,757	27%
Arkansas	0.71%	8,150	5.125%	418	1,772	24%
California	13.00%	149,251	5.750%	8,582	24,298	35%
Colorado	1.70%	19,560	2.900%	567	1,970	29%
Connecticut	1.67%	19,226	6.000%	1,154	3,475	33%
D. of Columbia	0.26%	3,037	5.750%	175	682	26%
Florida	5.47%	62,786	6.000%	3,767	14,862	25%
Georgia	2.78%	31,867	4.000%	1,275	4,874	26%
Hawaii	0.41%	4,697	4.000%	188	1,560	12%
Idaho	0.37%	4,303	5.000%	215	782	28%
Illinois	4.75%	54,528	6.250%	3,408	6,565	52%
Indiana	1.96%	22,473	5.000%	1,124	3,606	31%
Iowa	0.92%	10,569	5.000%	528	1,756	30%
Kansas	0.89%	10,182	4.900%	499	1,745	29%
Kentucky	1.17%	13,404	6.000%	804	2,656	30%
Louisiana	1.26%	14,493	4.000%	580	2,665	22%
Maine	0.40%	4,548	5.000%	227	818	28%
Maryland	2.18%	25,021	5.000%	1,251	3,326	38%
Massachusetts	2.86%	32,833	5.000%	1,642	3,756	44%
Michigan	3.43%	39,369	6.000%	2,362	7,686	31%
Minnesota	1.90%	21,773	6.500%	1,415	4,768	30%
Mississippi	0.72%	8,223	7.000%	576	2,330	25%
Missouri	1.83%	21,021	4.225%	888	2,805	32%
Nebraska	0.57%	6,547	5.000%	327	1,017	32%
Nevada	0.73%	8,329	6.500%	541	2,049	26%
New Jersey	3.76%	43,220	6.000%	2,593	5,759	45%
New Mexico	0.49%	5,603	5.000%	280	1,731	16%
New York	7.89%	90,585	4.000%	3,623	8,449	43%
North Carolina	2.60%	29,795	4.000%	1,192	3,430	35%
North Dakota	0.19%	2,174	5.000%	109	403	27%
Ohio	3.78%	43,356	5.000%	2,168	6,288	34%
Oklahoma	1.00%	11,476	4.500%	516	1,550	33%
Pennsylvania	4.35%	49,932	6.000%	2,996	7,238	41%
Rhode Island	0.37%	4,233	7.000%	296	699	42%
South Carolina	1.17%	13,375	5.000%	669	2,507	27%
South Dakota	0.23%	2,669	4.000%	107	464	23%
Tennessee	1.79%	20,492	6.000%	1,230	4,483	27%
Texas	7.02%	80,626	6.250%	5,039	17,903	28%
Utah	0.63%	7,260	4.750%	345	1,480	23%
Vermont	0.20%	2,319	5.000%	116	356	33%
Virginia	2.69%	30,836	3.500%	1,079	2,992	36%
Washington	2.21%	25,367	6.500%	1,649	6,078	27%
West Virginia	0.48%	5,454	6.000%	327	1,086	30%
Wisconsin	1.82%	20,916	5.000%	1,046	3,613	29%
Wyoming	0.17%	1,924	4.000%	77	406	19%

* "Readily-taxable" services consist of all services consumed by households except: housing, health care, education, transit, banking, insurance, legal, and funeral services. See text for description of data sources.

Table 2
State Sales Taxation of Selected Household Services ("T" = taxable)

	AL	AZ	AR	CA	CO	CT	DC	FL	GA	HI	ID	IL	IN	IA	KS	KY	LA	ME	MD	MA	MI	MN	MS
Veterinary services										T													
Horse boarding/training										T													
Pet grooming										T					T							T	
Landscaping/lawn care			T			T	T			T			T	T	T							T	T
Self storage		T						T		T				T									
Marina services		T	T				T	T		T					T								T
Residential electricity	T	T	T						T	T		T	T	T			T	T			T	T	
Residential gas	T	T	T						T	T		T	T	T			T				T	T	
Investment counseling										T				T									
Barber shops/salons										T				T									
Carpet/uphol. cleaning		T				T				T				T			T					T	
Dating services						T				T				T									
Diaper service	T	T							T	T			T	T	T		T						T
Garment alter./repair						T	T	T		T				T	T		T					T	
Health clubs			T							T	T			T	T							T	
Laundry/dry cleaning							T			T				T	T		T		T			T	T
Personal instruction						T				T													
Shoe repair			T			T	T	T		T				T	T		T				T		T
Swimming pool clean.			T			T	T			T				T	T							T	
Tuxedo rental	T	T	T	T		T	T	T	T	T	T		T	T	T	T	T		T		T		T
Exterminating						T		T		T	T			T	T							T	T
Auto washing			T			T		T		T				T	T							T	T
Auto road svc./towing										T				T	T							T	
Auto maint./painting			T			T	T	T		T				T	T		T					T	T
Parking lots/garages		T	T			T	T	T		T				T			T					T	T
Auto rustproofing		T	T			T	T	T		T				T	T		T					T	T
Parimutuel racing adm.		T	T			T		T	T		T			T	T	T			T			T	T
Amusement park adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T			T	T
Bowling alleys	T	T	T			T		T	T	T	T			T	T		T					T	T
Cable TV			T			T	T	T		T			T	T	T			T	T			T	T
Circus/fair adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T			T	T
Private club membersh.		T				T		T		T				T	T		T					T	
Cultural event adm.	T	T	T			T		T	T	T	T			T	T	T			T			T	
Prof. sports adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T			T	T
Private limo svc.		T				T	T		T	T				T									
Labor chg., auto repair			T			T	T	T		T				T	T		T						T
Labor chg., TV repair			T			T	T	T		T				T	T		T						T
Labor chg., remodeling		T								T				T									
Extended svc. contracts			T	T	T	T	T	T		T	T	T		T	T		T						T
Installation charges					T			T		T					T		T					T	T
# of these services taxed	9	18	22	2	2	25	18	22	11	39	10	3	6	34	27	6	20	2	8	0	4	24	21

Source: Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*, Research Report No. 147 (Washington, DC: Federation of Tax Administrators), April 1997. Partially updated for known changes. See report for extensive footnotes that affect classification as taxable or exempt. Available at www.taxadmin.org/fta/pub/services/services.html.

MO	NE	NV	NJ	NM	NY	NC	ND	OH	OK	PA	RI	SC	SD	TN	TX	UT	VT	VA	WA	WV	WI	WY	
				T									T										Veterinary services
					T								T	T						T			Horse boarding/training
T			T	T	T					T			T	T	T	T				T	T		Pet grooming
				T	T			T		T			T		T				T	T	T		Landscaping/lawn care
				T	T								T							T			Self storage
T			T	T	T			T		T			T	T		T			T	T	T	T	Marina services
	T			T		T							T			T				T	T	T	Residential electricity
T	T			T		T	T						T			T				T	T	T	Residential gas
				T									T										Investment counseling
				T									T										Barber shops/salons
				T						T			T	T	T					T	T		Carpet/uphol. cleaning.
				T	T								T		T				T	T			Dating services
	T			T		T		T				T	T	T	T	T		T	T	T		T	Diaper service
				T				T					T	T	T	T			T	T	T	T	Garment alter./repair
T	T			T				T				T	T	T	T		T			T	T		Health clubs
				T		T				T		T	T	T	T	T			T	T	T	T	Laundry/dry cleaning
				T									T							T			Personal instruction
				T				T					T	T	T	T			T	T	T	T	Shoe repair
			T	T	T			T					T		T				T	T	T		Swimming pool clean.
	T	T		T	T	T	T	T	T	T		T	T	T	T	T	T	T	T	T	T	T	Tuxedo rental
	T		T	T	T			T		T			T		T				T	T			Exterminating
	T		T	T	T			T		T			T	T		T			T	T	T	T	Auto washing
	T		T	T	T					T			T	T					T	T	T	T	Auto road svc./towing
	T		T	T	T			T		T			T	T		T			T	T	T	T	Auto maint./painting
				T	T				T				T	T	T				T	T	T		Parking lots/garages
	T	T	T	T	T			T		T			T	T		T			T	T	T	T	Auto rustproofing
T	T			T		T	T		T				T	T	T	T	T			T	T	T	Parimutuel racing adm.
T	T		T	T	T	T	T		T			T	T	T	T	T	T			T	T	T	Amusement park adm.
T	T			T			T		T			T	T	T	T	T	T		T	T	T		Bowling alleys
	T			T							T	T	T	T	T		T			T	T		Cable TV
T	T		T	T	T	T	T		T			T	T	T	T	T	T			T	T	T	Circus/fair adm.
T	T			T	T		T	T	T			T	T	T	T		T			T	T		Private club membersh.
T	T		T	T		T	T		T			T	T	T	T	T	T			T	T	T	Cultural event adm.
T	T		T	T	T	T	T		T			T	T	T		T	T			T	T	T	Prof. sports adm.
				T					T				T					T		T		T	Private limo svc.
			T	T	T			T		T			T	T		T			T	T	T	T	Labor chg., auto repair
			T	T	T			T		T			T	T	T	T			T	T	T	T	Labor chg., TV repair
			T	T	T								T		T				T	T			Labor chg., remodeling
	T		T	T	T			T		T		T	T	T	T	T		T	T	T	T		Extended svc. contracts
	T		T	T	T			T		T			T	T	T	T			T	T	T	T	Installation charges
11	20	2	17	39	23	10	9	17	10	15	1	12	40	27	24	22	10	4	21	37	29	21	#of these services taxed

State-Generated Estimates of Revenue Gains from Taxing Services

Executive and legislative branch agencies in several states have also recently estimated either the potential revenue gain from extending the sales tax to selected services or the revenue foregone due to the failure to tax them.[16] These estimates can be useful to other states in assessing the revenue they might gain from broadening the sales tax base. Table 3 summarizes several of these recent estimates. It shows that:

- Texas' sales tax exemptions for just five categories of services consumed by households cost the state over $600 million in FY01 receipts. The five categories were labor services used in residential construction, residential remodeling and repair services, barber and beauty services, auto maintenance and repair, and car washes.[17]

- The revenue foregone as a result of Michigan's sales tax exemptions for virtually all services purchased by households and businesses equals $4.8 billion, approximately three-fourths of sales taxes collected on sales of goods in the state.[18]

- Kentucky Governor Paul Patton's January 2003 proposal to expand the sales tax to include such services as car washes, laundry and dry-cleaning, and pest control, was predicted to raise approximately $50 million in FY04, an amount equal to two percent of forecasted FY04 sales tax revenues.[19]

- Ohio Governor Robert Taft's January 2003 proposal to expand the state's sales tax base to include such services as entertainment admissions and real estate agent services was predicted to raise more than $250 million in FY05 revenue.

In assessing the estimates for Texas and Michigan just cited, it is important to keep in mind that the revenue foregone from failing to tax a particular service does not necessarily equal the revenue that would be gained by taxing it. Compliance with a new tax is often considerably less than 100 percent until businesses can be educated about their obligations. In addition, the enactment of a new sales tax on a particular service may well include exceptions of various kinds, for example, for purchases of the service by non-profit organizations. With these caveats in mind, the figures in Table 3 reinforce the conclusion that substantial amounts of revenue could be raised in many states by expanding the sales taxation of services.

Expanded Taxation of Services Is Essential to Ensuring Adequate Sales Tax Revenue over the Long Run

Taxes are levied to finance desired public services. The cost of providing an existing set of state services is likely to rise over time due to such factors as inflation, overall population growth, and above-average growth in particular population cohorts that tend to be disproportionately served by state programs (such as the elderly and school-aged children).

Table 3
State Estimates of Revenue Gained/Foregone by Taxing/Exempting Selected Services
($millions)

Texas

Estimated FY01 revenue foregone from exemptions for:

New residential construction labor	$252.5	
Residential repair and remodeling	81.8	
Barber and beauty	48.3	
Auto maintenance and repair	221.0	
Car washes	19.0	
	$622.6	≈ 4% of FY01 sales tax revenue

Michigan

Estimated FY03 revenue foregone from exemptions for:

Accommodations and food service	$ 6.9	
Admin. and support and waste mgmt.	717.7	
Arts, entertainment, and recreation	166.4	
Educational services	52.4	
Health care and social assistance	1914.9	
Other services (except public admin.)	464.2	
Professional, scientific, and technical	1133.6	
Real estate and rental and leasing	350.2	
	$4806.3	≈ 76% of FY03 sales tax revenue

Kentucky

Estimated FY04 revenue gain from expanding sales tax to include:

Laundry, dry cleaning, linen, uniform	$15.3	
Janitorial, carpet, and upholstery cleaning	17.9	
Exterminating and pest control	3.9	
Participatory admissions fees	8.2	
Car washes	3.5	
	$48.8	≈ 2% of FY04 sales tax revenue

Ohio

Estimated FY05 revenue gain from expanding sales tax to include:

Entertainment admissions	$54.2	
Self storage and parking	25.5	
Selected personal care (not barber)	2.5	
Cable, satellite, and pay-per-view TV	88.3	
Interior and landscape design	9.0	
Dry cleaning and laundry	16.4	
Real estate agent services	63.7	
Real estate title search	10.7	
	$270.3	≈ 4% of FY05 sales tax revenue

It is a fundamental goal of state tax policy to ensure that both individual taxes and the tax system as a whole are structured in a way that the revenues generated keep pace with the cost of providing the services that the taxes are intended to finance. If this objective is not achieved, the state is likely to lurch from fiscal crisis to fiscal crisis. Revenues will continually threaten to fall short of costs, and elected officials will constantly have to revisit and adjust the tax structure by raising rates, broadening the tax base, or imposing new kinds of taxes or fees.

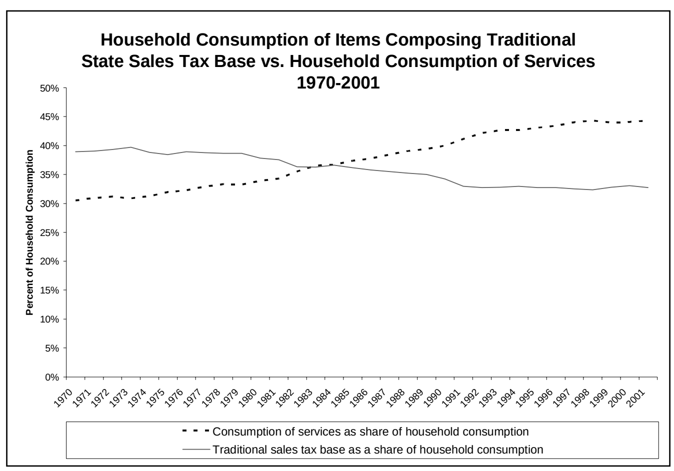
The substantial omission of services from state sales tax bases appears to have contributed to just such a scenario.

- Between 1970 and 2001, the average state sales tax rate increased from 3.5 percent to 5.3 percent.

- Sales tax rates were raised by at least two percentage points in half the states levying them. Twenty-four states permanently increased their sales tax rates more than once during this period.

- Despite a 48 percent increase in the average state sales tax rate between 1970 and 2001, total state sales tax revenue as a share of total household consumption in the economy increased only 18 percent, from 2.2 percent of consumption to 2.6 percent.[20]

Figure 1



In short, policymakers in many states were compelled to increase sales tax rates substantially in order to maintain the revenue yield of the tax and eke out a modest net increase.

Some states did narrow the base of their sales taxes intentionally over this period; for example, many states exempted food. Nonetheless, it appears that a major reason sales tax *revenue* as a share of total consumption increased much more slowly than sales tax *rates* is that purchases of goods typically subject to sales tax fell as a share of household consumption while purchases of services that are usually tax-exempt rose as a share of consumption.[21] Figure 1 illustrates the long-term trends in household consumption and confirms the steady shift from tangible goods to services:

- The traditional sales tax base, purchases of durable and non-durable goods with the exception of groceries (which the majority of states exempt), fell from 39 percent of household consumption in 1970 to 33 percent in 2001.

- Over the same interval, consumption of services rose from 31 percent to 44 percent of total household purchases.[22]

If more services had been included in the tax base, it is likely that sales tax revenue growth would have more closely tracked economic growth. A 1993 study by economists Robert A. Bohm and Eleanor D. Craig concluded that the extent to which services were included in state sales tax bases was positively correlated over the 1968-83 period with the “elasticity” of the tax — that is, the extent to which growth in the sales tax kept pace with growth in state economies.[23]

The Shift to Services Seems Likely to Continue

While the shift toward purchases of services over the last 30 years appears to have eroded the state sales tax base and compelled elected officials to raise sales tax rates to maintain the revenue yield of the tax, that does not prove the trend will continue. Nonetheless, several factors point toward continuation of the long-term shift of household spending toward services:

- For many types of services, there are inherent limits on the ability of technology to increase productivity and reduce costs. A personal trainer or nursing-home worker can care for only so many clients in a day; an actor can put on only so many performances. In contrast, there is still enormous unfulfilled potential to improve productivity in manufacturing through further automation — particularly in developing countries where an increasing share of the goods sold in the U.S. are made. If the price of goods is held down by further gains in manufacturing productivity, the share of total household spending devoted to goods is likely to fall even if the actual quantity of goods purchased holds steady.[24]

- Several basic economic and demographic trends in American society point toward continued rapid growth in spending on particular services. For example, spending on health and elder care services seems likely to accelerate as the baby boom population bulge ages.

- As American society becomes more affluent (on average), the desire for more leisure time grows. It seems likely that the desire for and the availability of more leisure time for many households tends to boost spending on services relative to spending on goods; families that can afford to do so hire housekeepers and lawn care services to obtain more leisure time, and they spend their leisure time consuming health club memberships, surfing the Internet and watching cable TV, and going to movies and sporting events.

In sum, it seems likely that sales of lightly-taxed services will continue to represent a growing share of total sales to households and businesses in the U.S. economy, and sales of generally-taxed goods are likely to continue their relative decline.

Preserving Sales Tax Revenue

If the traditional, goods-dominated sales tax base continues its relative decline, states have essentially three options if they wish to preserve the share of state spending that is financed by the sales tax. They can:

- continue to increase sales tax rates applicable to purchases of goods — as they have done in recent decades;

- eliminate existing exemptions applicable to sales of certain goods; or

- broaden the sales tax base to include additional services.

The first option is increasingly constrained. Combined state and local sales tax rates in many areas of the country are in the 8-10 percent range. Already, many consumers are switching their purchases to the Internet or shopping in lower-tax states in order to evade sales taxes.[25] Imposing still higher sales tax rates on the current narrow sales tax base likely would stimulate even greater sales tax evasion.[26]

The second option also has serious drawbacks. Expanding the sales taxation of currently exempt purchases of goods by *businesses* could have adverse economic impacts, as discussed below. Eliminating the relatively limited sales tax exemptions applicable to purchases of goods by *households* would have adverse distributional effects in most cases, since the exemptions tend to apply to necessities like food and medicine that weigh heavily in the budgets of low-income households.

Thus, states may have only one truly viable option if they wish to preserve for the long term the critical role that state sales taxes play in financing public programs — broadening the base of the tax to include more sales of services.

Expanded Taxation of Services May Reduce Sales Tax Revenue Volatility

In addition to improving the long-run revenue-generating potential of the sales tax, there is some evidence that broadening the sales tax base to include more services can reduce the year-to-year volatility of sales tax revenues as the economy goes through its cycles of rapid expansion, slow growth, and contraction. Reducing the cyclical variability of taxes is often considered a desirable policy goal because it means that revenues from the taxes will tend to hold up during economic recessions, when the demand for many state services increases.

A large share of sales tax receipts are generated by sales of big-ticket consumer durables like cars, household furniture, and appliances. Purchases of such items often decline sharply during economic downturns as consumers decide to make due with their current possessions. Conversely, purchases of such items often accelerate around the peak years of economic expansions as consumers gain confidence about their long-term job prospects and decide they can afford to buy a new car, renovate their homes, or invest in the home theater system they have been craving.

It reasonably can be hypothesized that household purchases of many services do not vary as much with economic conditions as do purchases of durable goods. People need to get their hair cut, their work clothes dry-cleaned, and their medical problems taken care of regardless of economic conditions, and they will tend to do so as long as they themselves are not out of work. Purchases of some services may actually tend to rise in recessions; for example, consumers may decide to repair cars rather than replace them. Thus, if the consumption of at least some services is less volatile than the consumption of consumer durables, it is reasonable to posit that the addition of services to a sales tax base dominated by durables should make sales tax collections overall somewhat less variable.[27]

Empirical research into this question has produced mixed results, but on balance suggests that expanding the sales tax base to encompass more services does reduce sales tax volatility at least moderately. A 1992 study by economists Richard F. Dye and Therese J. McGuire, for example, simulated growth in a hypothetical state sales tax base that incorporated personal services (like haircuts), personal business services (like investment counseling), recreation services, utilities, and telephone service. The study found such a broad sales tax base to be less volatile than the goods-dominated base characteristic of most states.[28]

Sales Taxation of Services and Tax Fairness

The fairness of taxes is usually evaluated along two dimensions: "horizontal equity" and "vertical equity." A tax is "horizontally" equitable if it is structured to impose the same tax liability on two taxpayers in similar economic circumstances — most often, two taxpayers with the same income. "Vertical equity" refers to the distribution of tax liabilities among people with *different* incomes.

Tax experts almost unanimously would agree that taxes should be structured to maximize horizontal equity, recognizing that practical administrative issues may sometimes require a departure from this principle. Consensus does not exist, however, with regard to the precise appropriate distribution of tax liabilities among income groups. Nonetheless, a large majority of tax experts likely would agree that the distribution of taxes as a whole should not be "regressive" — that is, compel lower-income taxpayers to devote a greater share of their incomes to paying taxes than higher-income taxpayers must. A smaller majority likely would agree that tax burdens should be at least somewhat "progressive," that is, result in upper-income taxpayers devoting a greater share of their incomes to paying taxes than lower-income taxpayers do. The rationale for a progressive tax structure is that upper-income taxpayers are able to devote a smaller share of their incomes to the necessities of life than can lower-income taxpayers, and therefore have a greater ability to pay taxes.

Taxing Services Improves Horizontal Equity

Enhancing the "horizontal equity" of the sales tax is a compelling rationale for expanding the taxation of services. Fundamentally, the sales tax is intended to be a broad-based tax on household consumption. As the tax is currently structured in nearly all states, however, two taxpayers with the same incomes, who save the same amount of that income and spend the rest, can pay significantly different amounts of sales tax. The individual who prefers to devote most of her consumption dollars to the purchase of goods is likely to pay a much greater amount of sales tax each year than will the person who prefers to spend a large share of her disposable income on services. Yet both are equally satisfying their particular needs and wants through spending and are consuming equal amounts of society's output. Given that the sales tax is intended to tax people on their consumption of resources, there is no reason why the individual who purchases services should not also pay tax on that consumption. Of course, state policymakers can choose not to tax particular services to achieve other goals, such as improving vertical equity, minimizing administrative difficulties, or encouraging (or not discouraging) the consumption of certain services. Nonetheless, the principle of horizontal equity generally supports the proposition that most household services that currently are not subject to sales taxation should be.

The violation of the horizontal equity principle arising from non-taxation of services is particularly glaring in those situations in which taxed goods and untaxed services are close substitutes for one another. In many states, for example, a person who likes to rent movies at the local video store will pay sales tax while a person who likes to order pay-per-view movies via cable TV will not. A person who buys disposable diapers may pay sales tax while a person who contracts with a diaper service may not. Again, there is no good reason why people with identical levels of spending should pay different amounts of sales tax based on their consumption choices. Subjecting additional services to sales taxation will reduce the "horizontal" inequities present today in the sales tax systems of nearly all states.

Taxing Services Broadly Should Not Significantly Increase The Regressivity of the Sales Tax

Sales taxes are highly regressive. According to a recent study by the Institute on Taxation and Economic Policy (ITEP), the 20 percent of families with the lowest incomes devote 5.9 percent of their incomes to paying sales tax, while the most affluent one percent of families devote just one percent of their incomes to paying the tax.[29]

Sales taxes — and indeed all consumption taxes that are imposed at a flat rate — are inherently regressive. The tax is imposed only on spending, yet upper-income people save rather than spend large shares of income; the share of income saved tends to rise as one proceeds up the income scale. Thus, even if the sales tax were imposed on all household spending, the share of income devoted to paying the tax would fall at upper-income levels because the share of income devoted to consumption generally falls.

In many states, policymakers have consciously chosen to mitigate the inherent regressivity of sales taxes by exempting from taxation purchases of goods that constitute a disproportionately-large share of the budgets of low-income households. The most common such exemptions are those for groceries, utilities and fuel oil, prescription medicines and medical supplies, and clothing. A question naturally arises as to whether the regressivity of the sales tax would be further reduced if a state *expanded* the sales taxation of services, many of which appear at first blush to be disproportionately purchased by upper-income households.

Of course, it is not difficult to identify some services that *are* disproportionately purchased by relatively-affluent households and almost never purchased by low-income households — country club memberships, the services of investment counselors, and swimming pool cleaning services for example. Undoubtedly, expanding the sales tax to purchases of such services would reduce the share of the tax paid by low-income consumers.

Limiting the sales taxation of services to those services predominantly purchased by affluent households would mean foregoing many of the other potential benefits of sales tax base expansion, however. For example, not much revenue would be gained. Nor would the long-run revenue-generating potential of the sales tax be significantly enhanced. The shift of household consumption toward services is occurring at all income levels, not just among high-income segments of the population; it therefore is essential that there be broad-based taxation of services if the role of the sales tax in state tax structures is to be preserved. Similarly, horizontal inequities created by taxation of most goods and exemption of most services are present within all income classes and can only be relieved significantly by broad taxation of services.

If states extend their sales taxes to a broad set of services purchased by households at all income levels, the question remains: what is the likely distributional impact of doing so? Unfortunately, the limited empirical research on this question fails to give a clear-cut answer. The various studies suggest that the answer is affected critically by both the pre-existing state sales tax base and the specific services to which the sales tax is extended:

- A 1990 study by Minnesota House of Representatives economists found that consumption of a broad group of personal and household services was slightly less skewed toward low-income classes than consumption of the items making up that state's existing sales tax base.[30] (The group of services studied consisted of water and sewer, personal care, household operation, auto repair, and miscellaneous personal services, as well as some recreation services not already subject to tax.) Such a distribution of consumption of services implies that extending the sales tax to the complete group of untaxed services would slightly reduce the regressivity of the tax. While purchases of water/sewer and personal care services were more regressive than the existing sales tax base, all the other categories were less regressive. Thus, taxing the *entire* group would slightly *reduce* regressivity overall. It is important to note that this would not have been the case had medical care services also been taxed; consumption of such services was nearly twice as skewed toward low income classes as was consumption of items composing the existing sales tax base.

- Similarly, a 1991 study by economists at Vanderbilt University found that taxing the specific group of services encompassed by Florida's 1987 base expansion slightly reduced the overall regressivity of the sales tax. When the tax on these services was repealed and the revenue replaced with a sales tax rate increase of one percent, the regressivity of the sales tax increased.[31] (It should be noted, however, that the study relied on household consumption patterns as of 1972-73, raising questions about its validity today.)

- The ITEP study cited above provides state-by-state data on the distribution of sales tax liabilities across income groups. By comparing the regressivity of the sales taxes of two states whose sales taxes are similar except with respect to the breadth of service taxation, it is possible to draw tentative conclusions about the distributional impact of taxing services. New Mexico taxes virtually all services and goods, including food. Idaho's sales tax rate is the same as New Mexico's, and the state also taxes food. However, Idaho taxes far fewer services. According to ITEP, the 20 percent of families in New Mexico with the lowest incomes (the "bottom quintile") devote 6.3 percent of income to paying direct sales taxes on purchases. (This measure excludes sales taxes imposed on businesses but passed through to consumers through the prices businesses charge.) The top 20 percent of New Mexico families devote 2.7 percent of their

> incomes to direct sales taxes. The 6.3 percent share of income devoted to paying sales taxes by the bottom quintile is 2.3 times the 2.7 percent share paid by the top quintile in New Mexico. That multiple in Idaho is also 2.3, suggesting that very broad taxation of services may not have a significant effect one way or another on the distribution of sales tax liability among income groups.[32]

The limited research that has been done does not seem to confirm the often-stated hypothesis that extending the sales tax to a wide array of services will significantly *reduce* the regressivity of state sales taxes.[33] The more important conclusion to draw, however, may be that broadly taxing services is unlikely to worsen the regressivity of the sales tax, either. The necessity of including services in the sales tax base in order both to preserve the long-run yield of the tax and to achieve *horizontal* equity are compelling arguments in and of themselves for implementing such a policy. The fact that there does not seem to be a significant negative impact on the *vertical* equity of the sales tax should be reassuring to policymakers concerned about that issue.

Expanding the Taxation of Services to Raise Additional Revenue Still Could Burden Low-income Households; Relief Is Warranted

The previous section concluded that taxing services broadly does not appear to change significantly the distributional impact of the sales tax itself. That does not mean, however, that expanding the taxation of services would not increase the tax burden of low-income households. Not all services are luxuries; low-income households need to have their plumbing and cars repaired just as upper-income households do. Therefore, expanding the sales taxation of services will increase the absolute amount of sales taxes many low-income consumers pay. In addition, sales taxes are inherently regressive because upper-income households save rather than consume a substantial portion of their incomes. If expanding the sales taxation of services increases the share of total state tax revenue contributed by the sales tax, the regressivity of the tax system taken as a whole is likely to increase even if the regressivity of the sales tax itself does not change. Since most state tax systems are composed of a mix of regressive taxes (like the sales tax) and progressive taxes (like the income tax), increasing the role of the regressive sales tax in the overall mix will tend to increase the regressivity of the system as a whole.

There are a number of ways to ensure that expanding the sales taxation of services is not excessively burdensome to lower-income households in absolute and/or relative terms. The first is to cut the sales tax rate just enough to ensure that the combination of the base expansion and the rate reduction neither raises nor reduces sales tax revenue. Under such a policy, low-income households generally would not pay substantially more sales tax measured in absolute dollars, since the sales taxes on newly-taxable services would be offset by reduced sales taxes on already-taxable goods and services they purchase. A "revenue neutral" sales tax package combining base expansion and an offsetting rate reduction also would tend to shield low-income households from bearing a greater *share* of the overall state tax burden, since the proportions shares of regressive and progressive taxes in the overall mix would not change if no net sales tax revenue were raised.

At the present time, of course, most expansion of the sales taxation of services that is being contemplated is for the express purpose of raising revenue; policymakers are not looking to make offsetting cuts in sales tax rates. Nonetheless, significant shares of the state revenue shortfalls that are spurring interest in sales tax base expansions are temporary and due in part to the slowdown in economic growth. When the economy returns to a more normal growth trend and revenues bounce back, policymakers are likely to reverse recession-motivated increases in taxes, just as they have done following many previous downturns. In short, states that expand the taxation of services to raise revenue may well be in a position a few years from now to implement a sales tax rate cut and thereby ensure that low-income households are not permanently burdened by the broadening of the sales tax base.

A second option states could pursue to mitigate the impact on low-income households of expanding the taxation of services would be to couple this with an increase in state personal and/or corporate income taxes. Because these taxes are progressive — absorb greater shares of the incomes of affluent households than of lower-income households — a tax package that combined expanded taxation of services with an income tax increase could be structured in a way that the *share* of state taxes paid by lower-income population groups would remain more-or-less constant. And if the revenue generated by the income tax increase were used to finance a reduction in the sales tax rate, low-income households could be protected from an absolute increase in their sales tax burdens as well.

A third approach to ensuring that expanding the taxation of services would not burden lower-income households would be to enact simultaneously offsetting tax cuts that are *targeted* to such households. As discussed in the text box on the next page, a number of states have, in effect, rebated sales taxes paid by some low-income households by providing tax credits administered through the state income tax. States could estimate the average amount of additional sales tax that would be paid by low-income households as a result of taxing additional services and either expand existing low-income credits (such as state "earned-income tax credits) or enact new ones.

Expanding the sales taxation of services has merit as a mechanism for raising additional revenue to enable states to cope with near-term budget shortfalls. It is also essential if the long-run yield of the sales tax is to be maintained. It is not necessary, however, for states to impose disproportionate burdens on low-income households to achieve either goal. As discussed in this section, states have a number of options for making offsetting adjustments both in the sales tax itself and in other state taxes to mitigate the impact of base expansion on low-income families and individuals. With the same goal in mind, policymakers can also reasonably choose to maintain the sales-tax-exempt status of certain services that constitute a particularly large share of the budgets of low-income households, such as apartment rentals, health care, and child care. As stressed throughout this report, optimal taxation of services entails balancing revenue, equity, and other tax policy goals.

Expanded Taxation of Services Can Improve the Allocation of Economic Resources

Most taxes hold the potential to influence the economic choices of consumers, businesses, or workers. Economists generally argue that resources are allocated optimally when

Refundable Tax Credits or Rebates Can Offset the Impact on Low-Income Households of Expanding the Sales Taxation of Services

As they expand the sales tax base to include more services, states can take actions to offset the impact on low-income households — fully or partially. For example, states can estimate the additional sales tax liability that will result for low-income households of varying characteristics (for example, households with different numbers of children or headed by an elderly individual) and then enact offsetting, targeted *cuts* in their income taxes. One of the best mechanisms to achieve this would be to enact or expand a refundable income tax credit for low-income wage earners. Twelve states currently have refundable "earned-income tax credits" (EITCs) in place; they are usually calculated as a straight percentage of the federal EITC for which the household is eligible and thus phase out as income increases.[1] The fact that the state EITC is refundable means that even if the recipient had zero state income tax liability, she could be provided an additional EITC refund roughly equal to the estimated increase in her sales tax liability resulting from expanded taxation of services.

A new or expanded EITC could be used to mitigate the impact of sales tax base expansion on low-income households with wage income. However, a different mechanism would be needed to assist other low-income households, such as those in which the adult members were retired, disabled, unemployed, or on welfare. Such mechanisms are already in use in some states to relieve sales tax burdens on some low-income households. Idaho and Oklahoma provide non-EITC-based refundable credits against the state income tax intended to offset a portion of the sales tax paid on food purchases by low-income taxpayers. Kansas, South Dakota, and Wyoming provide partial rebates for sales taxes paid on food purchases that are not administered as part of the state income tax (which the latter two states lack). These credits and rebates are usually flat amounts per household member, but South Dakota's phases down as income increases. A refundable income tax credit in Hawaii, which is intended to offset a range of taxes on low-income households (including the sales tax on food), also phases down with income. Although these kinds of credits have significant shortcomings and limitations, they do represent a model that could be modified and improved to help ensure that the expansion of the sales tax base to services does not excessively burden low-income families and individuals.[2]

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[1] Nicholas Johnson, *A Hand Up*, Center on Budget and Policy Priorities, March 3, 2003.

[2] For further discussion of using credits to offset the sales tax liabilities of low-income households, see: Nicholas Johnson and Iris J. Lav, *Should States Tax Food? Examining the Policy Issues and Options*, Center on Budget and Policy Priorities, May 1998, Chapter III, pp. 29-39.

these economic actors engage in transactions in the marketplace based on their own interests uninfluenced by taxes. A great deal of the work of public finance economists is aimed at understanding the economic incentives created by taxes and then designing tax policy that minimizes the impact of taxes on private economic decisions.

Combined state and local sales tax rates imposed on sales of goods are now in the range of 8-10 percent of the purchase price in many parts of the United States. Although the impact of taxes on economic decisions is often exaggerated, the fact that many consumer goods are taxed at such rates while other goods and most services are taxed at a zero rate is probably influencing consumption decisions to some extent. A recent study by economists David Merriman and Mark

Skidmore, for example, found that the absence of a sales tax on the majority of service transactions was a significant, independent contributor to the growth of the service sector of the U.S. economy.[34]

The failure to tax certain household services may be affecting consumer choices about what to buy in numerous subtle ways that could have an adverse impact on the efficient allocation of resources.[35] For example:

- Exempting repairs while taxing purchases of goods may influence some people to delay replacing items longer than they otherwise might. In the case of automobiles, appliances, furnaces, and similar items, this may have an adverse impact on the energy efficiency and/or pollution output of household operations.

- Likewise, exempting utility services from sales taxes may increase consumption of energy and lead to underinvestment in energy-efficient appliances.

- The failure to impose sales taxes on businesses like country clubs and ski resorts may artificially boost demand for these land-, energy-, and water-resource-intensive operations.

- The failure of states to tax services like Internet access, Internet-based telephone service, downloaded software, and other online services has given such companies an artificial economic advantage over traditional long-distance telephone providers, retail stores that sell software, magazine publishers, and other competitors.[36]

The lack of a sales tax on most services in many states also means that sales tax rates on goods must be significantly higher than they would otherwise be to raise a desired amount of revenue. Economists tend to favor broad tax bases and low rates, because high rates tend to magnify existing economic incentives imbedded in particular taxes. In the case of sales taxes, unnecessarily high tax rates contribute to economic inefficiency and misallocation of resources in at least two ways:

- The higher the sales tax rate on goods, the greater is the likelihood that some consumers will engage in interstate shopping to evade the tax. Tax-motivated cross-border shopping is particularly likely when a state with a relatively high sales tax rate borders a state without a sales tax or that exempts from the tax items like food and clothing that can constitute a significant share of a family's budget. Besides wasting gasoline, tax motivated cross-border shopping can result in sub-optimal use of economic resources. Although in-state merchants may have more efficient operations and therefore sell goods at lower prices, their obligation to impose sales tax can render the total price to the consumer higher than in the neighboring state and lead consumers to go there to shop. Similarly, unnecessarily high sales tax rates can stimulate purchases from less efficient Internet and mail-order catalog merchants.[37]

- Many states impose substantial sales taxes on business purchases of production inputs, and this can create undesirable economic incentives. (See pages 24-25 below.) For example, taxing business inputs can encourage companies to manufacture internally certain inputs used in "upstream" stages of the production process, rather than purchase them from more efficient independent producers that would be obligated to charge sales tax. The higher the sales tax rate imposed on business purchases of inputs, the stronger is the incentive to make rather than buy, and therefore the greater the potential misallocation of economic resources. Again, the more household services are subject to sales tax, the lower the sales tax rate applied to business purchases could be.

In sum, the exemption from sales taxation of many services probably is leading to some economic inefficiency and misallocation of resources. Expanding the sales taxation of services may reduce or eliminate some of these undesirable economic incentives.

Expanded Taxation of Services Can Improve Sales Tax Administration and Compliance

An expert on state taxation has written:

> 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 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 [by tax officials] is a tax that has poor compliance [on the part of taxpayers].[38]

When states tax most goods and exempt many services, thorny problems arise in defining and administering the line between taxable and exempt sales. The need to distinguish the two has led to many costly disputes between tax administrators and taxpayers and forced both to devote excessive resources to tax enforcement and compliance. These costs include developing regulations and educational materials to guide taxpayers, creating and maintaining certain business records solely for the purpose of satisfying tax authorities, and devoting additional staff — of both state revenue departments and businesses — to participation in audits and litigation.

Exempting services from sales taxes creates line-drawing difficulties in three main areas:

- distinguishing taxable goods from exempt services when retailers sell both;
- distinguishing taxable goods from exempt services when the service is delivered in the form of a physical good; and
- distinguishing taxable services from exempt services.

Many sellers of tax-exempt services also sell related taxable goods. This compels taxpayers to keep separate sales records for each and requires tax administrators to review these records in some detail to ensure that the proper amount of tax was charged and remitted.

Furthermore, taxpayers may be tempted to play games to profit from the distinction between taxable and exempt sales, creating the potential for disputes and litigation. For example, an interior decorator hired to do a living-room makeover can provide a lower price to his client at the expense of the state treasury by not marking up the cost of the (taxable) custom furniture purchased by the decorator and resold to the client as part of the project and, instead, boosting the (tax-exempt) charge for his design services by a similar amount. Even without a tax-avoidance motivation, a dispute can easily arise between the decorator and the tax authority about the proper allocation of the total charge between the decorating service and the furniture. If the service component of the transaction were also taxable, however, the tax authority would be indifferent about the allocation.

A second set of problems arises from difficulty in differentiating goods and services. Many services are ultimately embodied in physical goods — the services of a lawyer in a contract or will, of an architect in a blueprint, of a computer programmer in a CD-ROM, of a photographer in a set of negatives and prints. The fact that states often tax the goods in which the service is delivered but not the service itself has led to many disputes (including litigation) concerning whether the good is taxable at all and, if so, its taxable value relative to the value of the service that it embodies. If the underlying service is taxable, there is little reason to dispute how much of the value of the service is embodied in the good.

Finally, if states tax services partially rather than comprehensively, problems can arise in drawing the line between taxable and exempt services. For example, if a state taxes local telephone service but exempts cable TV service, what does it do when a cable TV company provides both for one fixed, bundled price? The state can compel the company to break down a separate charge for each on the bill so that the telephone service can be taxed. But this adds to the record-keeping cost of the seller and can lead to disputes about whether the seller is overcharging for the exempt service and undercharging for the taxable one. Again, if both services were taxable, such complications would be much less likely to arise.

II. Which Services *Could* States Tax? Which Services *Should* They Tax?

Once policymakers conclude that expanding the taxation of services can improve their states' short- and long-term fiscal outlook and the fairness, economic rationality, and ease of administration of the sales tax itself, they still confront important decisions about how to implement such a policy.

The most significant decision to be made is which services to begin taxing.[39] As officials consider their options, it can be useful to think of services as falling into three categories:

- services purchased primarily by businesses, such as
  - Railroad freight transportation
  - Payroll processing
  - Television advertising
- services purchased primarily by households, such as
  - Diaper service
  - Personal trainers
  - Cable TV
- services frequently purchased by both households and businesses, such as
  - Auto repair
  - Landscaping
  - Pest control.

Taxation of Business-to-Business Sales of Services

Economists generally counsel states to forego taxing the first category of services — so-called "business-to-business" sales. They make a number of arguments:

- The sales tax is intended to be a tax on consumption. Businesses do not consume; they produce. Taxing business inputs of any kind — whether tangible goods or services — arguably is inconsistent with the underlying rationale for the sales tax.

- Taxing business inputs — again, goods or services — can lead to tax "pyramiding." Pyramiding occurs when an input is subject to sales tax when purchased by the business and then, effectively, a second time when the business passes the cost of the input into the selling price of a good or service that is also subject to sales tax.[40] If that good or service is an input into a second business' production process, then further pyramiding can occur before a sale to a final household consumer takes place. Tax pyramiding potentially has a number of negative consequences:

  - When a household consumer purchases a good or service, a significant amount of the sales tax she is actually paying can be hidden in the purchase price of the item rather than be explicitly identified on the cash register receipt. Sales taxes hidden in the selling price of an item can have undesired distributional effects. The most commonly-cited study, by economist Raymond Ring, found that more than 40 percent of all sales taxes are paid by businesses on their purchases from other businesses.[41] The fact that a significant portion of sales taxes are hidden in the selling price of goods and services may encourage states to rely more on this regressive revenue source than they otherwise might. Moreover, there is some evidence that the hidden sales taxes are even more regressive than the visible sales tax added at the cash register, because necessities like food and utilities that often are tax-exempt nonetheless can have substantial sales taxes hidden in their prices.[42]

  - Tax pyramiding can lead to an inefficient allocation of resources. Taxation of a good or service that is a major cost item for a business can induce the business to produce the good or service in-house using its own employees (whose services to the employer are nearly always exempt from sales tax), even when an independent producer can provide the good or service more efficiently. Such tax-induced "vertical integration" can lead to unequal and haphazard sales tax burdens among competitors within an industry as well as between industries, depending upon the extent to which businesses can and do engage in it.

- Taxation of business inputs can impair the competitiveness of businesses and potentially impede state economic development. For example, if a California widget manufacturer charges higher prices in an effort to recoup sales tax it has paid on purchases of electricity, it could lose sales to a Nevada competitor that has not had to pay tax on electricity because Nevada does not tax that service. The California business can lose sales to the Nevada business anywhere — in California, in Nevada, or in any other state in which both companies are competing to sell widgets. Moreover, if electricity were a major component of the cost of producing widgets and the market for widgets were so competitive that California widget manufacturers could not increase their prices at all to recoup the tax paid on the electricity, widget manufacturers could be discouraged from locating or expanding production in California. To be sure, the negative effects of taxing business inputs are sometimes exaggerated; the sales tax paid on janitorial services, for example, seems likely to be too small an expense to influence a company's price structure or location decisions. But if a broad array of inputs is subject to sales tax, or if an input that is a particularly large cost item for a business is subject to sales tax, adverse impacts on business competitiveness and economic development are possible.

- Taxing business purchases of services can create some difficult administrative problems that are less likely to arise if sales taxes are confined to household services:

  - Such services as advertising, telecommunications, and legal services are often purchased for company-wide use. When that use occurs in multiple states, it is difficult to develop and administer rules to determine how and where such services should be taxed. In the absence of clear rules, businesses will develop their own ad hoc approaches to charging or paying the tax, and this is likely to lead to audit disputes and litigation. Moreover, if the rules for dealing with these kinds of purchases are not consistent among the states, the sale of the service can be taxed more than once or escape taxation entirely.

  - Businesses purchase services across state lines much more often than households do. For example, a corporation is more likely to have an out-of-state architect design its new headquarters than a homeowner is to design an addition to her house. To avoid putting in-state service providers that must charge sales tax at a competitive disadvantage vis-à-vis out-of-state competitors who need not charge the tax, states will need to impose an equivalent "use tax" on services purchased from out-of-state companies (just as they impose a use tax on purchases of goods). Use taxes have proven difficult to enforce, however, particularly as they apply to purchases by small businesses. The fewer business-to-business sales of services are taxed, the fewer use tax enforcement issues arise.

  - Because of concerns about the potential adverse economic impacts of taxing business inputs, states often provide sales tax exemptions for purchases of goods that are resold in the form in which they are purchased or that are "directly incorporated" into an item that is resold. Ensuring that these types of exemptions have been claimed legitimately has required substantial audit resources on the part of tax authorities and generated considerable litigation. Determining whether a purchase of a *service* has been "resold" or "directly incorporated" into an item is fraught with even more uncertainty and subjectivity than is the case with purchases of goods. Again, to the extent that states forego taxing purchases of services by businesses, these difficulties are avoided.

These are all legitimate arguments against taxing business-to-business sales of services that policymakers need to weigh. There are a number of additional points to consider, however, that may justify some taxation of business-to-business services:

- Not all taxation of business inputs leads to sales tax pyramiding. There are major categories of household consumption that are not subject to sales taxes now and that seem likely to remain tax-exempt. Taxation of inputs that are used to produce tax-exempt services does not lead to pyramiding. For example, states are prohibited by federal law from taxing sales of airline tickets. Therefore, households are not being subjected to "double taxation" if a state taxes an airline's purchases of jet fuel and meals, even if the tax is passed on to the consumer in the price of the ticket. Similarly, states that do not want to tax educational services provided by colleges directly and in full could reasonably choose to obtain some sales tax revenue from college students by taxing the electricity, janitorial, and food preparation services the college purchases from independent vendors.

- As noted above, substantial taxation of business purchases of goods that are production inputs already occurs. The higher the sales tax rate applicable to such purchases, the greater the potential interference with such business decisions as whether to produce the input in-house and where to locate production. A state's revenue needs may be so great that in addition to considering new taxes on household services, policymakers are contemplating an increase in the sales tax rate. If that is the case, it may be preferable from an economic efficiency standpoint to expand taxation of business-to-business sales of services in order to avoid taxing business-to-business sales of goods at an even higher rate.

- The number of self-employed persons in the United States is large and growing. Accordingly, there is increasing potential for such workers to purchase many goods and services on a sales-tax-free basis by claiming they are being purchased for business use when they are actually being purchased for personal use. Services with such tax-evasion potential include telecommunications, car and hotel rentals, restaurant meals, and computer and auto repair. Improperly deducting such purchases as business expenses is already leading to a significant loss of state income tax revenue, and exempting business purchases of such services from sales taxation would compound the revenue loss. It would place unreasonable burdens on sellers of services and tax authorities alike to police the eligibility of thousands of small businesses for sales tax-exempt purchases of many services that are often used by households and businesses. Indeed, claims by businesses that certain purchases qualify for legitimate sales tax exemptions already absorb substantial resources for auditing and litigation. Accordingly, for many services that are often purchased for both household and business use, the potential costs of tax evasion by small businesses may justify taxation of all sales of the service, to households and businesses alike. The cost of preventing tax evasion could exceed the economic benefits of exempting business purchases.

- Some business purchases of services are really a disguised form of providing compensation to employees and customers in the form of individual consumption directly paid for by the business. Common examples are company-owned country club memberships, skybox rentals and season tickets at sports venues, many "business" meals and rentals of "company" cars, "retreats" or "sales meetings" at resorts for customers, employees and their families, and even luxury hotel accommodations in connection with otherwise legitimate business travel. There is little justification for allowing such services to be purchased on a sales tax-exempt basis merely because they are being purchased by a business.

As noted several times in this report, deciding whether and how to expand the sales taxation of services demands a careful balancing of revenue needs, potential economic impacts, equity goals, and practical administrative issues. In most states that have decided to substantially expand their taxation of services, policymakers have tended to forego taxing business purchases of services that are both significant cost items for a majority of businesses and tend to be purchased by businesses almost exclusively — services like freight transportation, bookkeeping, data processing, and advertising.[43] They have been somewhat more willing to begin taxing business services that probably are relatively minor cost items for most businesses (such as janitorial services) or that are purchased widely by both households and businesses (such as photocopying and cellular telephone services). While taxing business purchases of even the latter kinds of services may represent a departure from a theoretically-ideal tax structure (which would impose no sales taxes on business inputs), doing so probably has relatively little adverse economic impact while sparing states the need to devote substantial resources to preventing tax evasion. Where a particular industry can make a credible case that taxation of a service that also is purchased by households has an especially adverse economic impact (for example, telecommunications purchased by financial institutions), elected officials have been willing to enact industry-specific exemptions. Such an approach may make more sense than an across-the-board exemption for all services purchased by businesses.

Taxation of Household Purchases of Services

Even if states forego taxing services that are predominantly purchased by businesses, there is a vast array of household services to which the sales tax can be applied. The 1997 survey of sales taxation of services by the Federation of Tax Administrators listed over 100 such services. The possibilities are considerably broader, however. Appendix I lists over 200 types of services, organized into the 20 categories shown in the text box to the right. The services have been gleaned from such federal government sources as the Gross Domestic Product Accounts, economic census, and Consumer Expenditure Survey, and from such non-federal sources as the North American Industrial Classification System manual and the Yellow Pages.

What Categories of Household Services Could States Tax?

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

New household services are constantly being developed as technology changes and new wants and needs emerge. Two years ago, Internet music subscription services did not exist; now there are at least four nationwide providers.[44] Ten years ago, few people probably knew what a "personal trainer" was; now they are common. The professional association for people who provide “personal life coaching” services already claims over 5,000 members.[45] As entrepreneurs perceive new profit-making opportunities, new services will continue to be invented. As discussed in the next section, states can either implement taxation of services in a way that will incorporate newly emerging services or can monitor the evolution of the service sector and update their tax policies accordingly.

III. The Legal Mechanics of Expanding the Sales Taxation of Services: Comprehensive vs. Incremental Approaches

Most state sales tax laws provide that all sales of goods are subject to sales tax unless they are explicitly declared to be exempt. If states wish to expand their taxation of services comprehensively, they can apply the same legal structure to services. For example, South Dakota's sales tax law provides:

> Tax on receipts from business services. There is hereby imposed a tax at the same rate as that imposed upon sales of tangible personal property in this state upon the gross receipts of any person from the engaging or continuing in the practice of any business in which a service is rendered. . . unless the service is specifically exempt from the provisions of this chapter.[46]

South Dakota's law then goes on to enumerate such exempt services as health care, education, and railroad transportation. For purposes of the following discussion, South Dakota's method of taxing services will be referred to as the "comprehensive approach."

At present, the sales tax laws of only Hawaii, New Mexico, and South Dakota implement the comprehensive approach. In all other states with a sales tax, services are subjected to sales taxation by being specifically enumerated as taxable. For purposes of the discussion, this method of taxing services will be referred to as the "incremental approach." Under the incremental approach, the list of taxable services often can be found in the definition of a "retail sale" or similar term. Iowa has among the most detailed enumeration of taxable services of any state; its listing of taxable services is shown in the text box on the next page.

Comprehensive and Incremental Approaches to Expanding Sales Taxation of Services: Relative Advantages and Disadvantages

In theory, it is possible to subject a given set of services to sales taxation either by specifically enumerating them or by declaring all services to be taxable with the exception of those carved out as exempt. Given the practical difficulty of carving out the thousands of distinct services provided in the economy, however, a large majority of services are likely to be subjected to sales taxation in one fell swoop under the comprehensive approach. This broad reach has some key advantages:

How Iowa Taxes Services

Iowa's sales tax law provides as follows:

> There is imposed a tax of five percent upon the gross receipts from the rendering, furnishing, or performing of services. . .
>
> The following enumerated services are subject to the tax imposed on gross taxable services: alteration and garment repair; armored car; vehicle repair; battery, tire, and allied; investment counseling; service charges of all financial institutions; barber and beauty; boat repair; vehicle wash and wax; carpentry; roof, shingle, and glass repair; dance schools and dance studios; dating services; dry cleaning, pressing, dyeing, and laundering; electrical and electronic repair and installation; rental of tangible personal property, except manufactured or mobile homes which are tangible personal property; excavating and grading; farm implement repair of all kinds; flying service; furniture, rug, upholstery repair and cleaning; fur storage and repair; golf and country clubs and all commercial recreation; house and building moving; household appliance, television, and radio repair; jewelry and watch repair; limousine service, including driver; machine operator; machine repair of all kinds; motor repair; motorcycle, scooter, and bicycle repair; oilers and lubricators; office and business machine repair; painting, papering, and interior decorating; parking facilities; pipe fitting and plumbing; wood preparation; licensed executive search agencies; private employment agencies, excluding services for placing a person in employment where the principal place of employment of that person is to be located outside of the state; sewage services for nonresidential commercial operations; sewing and stitching; shoe repair and shoeshine; sign construction and installation; storage of household goods, mini-storage, and warehousing of raw agricultural products; swimming pool cleaning and maintenance; taxidermy services; telephone answering service; test laboratories, including mobile testing laboratories and field testing by testing laboratories, and excluding tests on humans or animals; termite, bug, roach, and pest eradicators; tin and sheet metal repair; turkish baths, massage, and reducing salons, excluding services provided by massage therapists licensed under chapter 152C; weighing; welding; well drilling; wrapping, packing, and packaging of merchandise other than processed meat, fish, fowl, and vegetables; wrecking service; wrecker and towing; pay television; campgrounds; carpet and upholstery cleaning; gun and camera repair; janitorial and building maintenance or cleaning; lawn care, landscaping, and tree trimming and removal; pet grooming; reflexology; security and detective services; tanning beds or salons; and water conditioning and softening.

- Since new services are constantly being invented, the comprehensive approach ensures that the revenue yield of the sales tax is maintained without a need to continually amend the law to encompass each new service. Sellers of new services are not precluded from making a case to public officials that the service ought to be exempted for some reason, but in the meantime the revenues are collected. Since the sales tax is intended to be a general tax on consumption, a presumption of taxability of services provided to household consumers is appropriate.

- By ensuring that newly-invented services sold to households will be taxed until such time as policymakers decide to exempt them, the comprehensive approach should tend to reduce the regressivity of the sales tax. Most newly-invented services are likely to be marketed to affluent consumers with discretionary income to spend (think of personal trainers and cell phones with Internet access capabilities) or looking for ways to obtain more free time (think of the recent proliferation of firms that do errands for individuals or offer gift-buying advice).

- The comprehensive approach helps tax authorities sustain the taxability of a particular service if it is challenged by service providers. Sellers of previously-exempt services often will look for every legal opportunity to avoid having to impose a sales tax on their customers, fearing a decline in business and/or wishing to avoid the administrative costs of compliance. It can be quite difficult, however, to write a clear, watertight description of a service that a policymaker wishes to subject to sales tax. State legislators and state tax administrators generally are not experts in business, and services can be technologically complicated and highly industry-specific. Should a dispute about taxability arise in a state using the comprehensive approach, the burden of proof is on the seller to demonstrate that it qualifies for an exemption. In contrast, the burden of proof is on the tax authority to demonstrate that a particular business' sales satisfy the definition of an enumerated taxable service. Given the desire of many sellers to avoid charging tax if there is any ambiguity in the law, it is advantageous to tax authorities to structure the law so that all services are presumed to be taxable unless exempted.

The comprehensive approach to expanding sales taxation of services also is likely to have certain drawbacks:

- Unless policymakers have a clear picture of the service economy and carve out a very large number of exemptions, it seems likely that the comprehensive approach will tend to sweep into the sales tax base many services that policymakers might choose not to tax for economic, distributional, or practical administrative reasons upon more careful reflection. For example:

    - Many business-to-business sales of services are likely to become taxable under this approach, with the economic effects and administrative complications discussed above. Moreover, elected officials may be confronted with numerous unanticipated requests for sales tax exemption of the services and/or of inputs into their production, which can be costly and time-consuming to deal with.

    - States may subject to taxation services that often are provided on an informal basis by individuals who are no more likely to comply with sales tax collection obligations than they are to report their incomes for income tax purposes. Sales taxation of such services may put legitimate businesses selling the same services at a competitive disadvantage and may generate substantial opposition for that reason.

- Even if the specific services that become taxable under the comprehensive approach pose no such problems, the sheer number of services and vendors that become taxable under this approach may strain the administrative resources of state tax departments. New retailers must be registered, they must be informed about their tax collection obligations through the preparation and distribution of general educational materials and regulations, their sales tax returns must be processed, and they must be audited for proper compliance. To be sure, the additional staff and other resources needed to carry out these activities is sometimes exaggerated; many sellers of services are already fully integrated into the state's sales tax administration system because they collect and remit tax on their sales of already-taxable goods and services or pay use tax on their purchases. Nonetheless, some additional personnel are likely to be needed; comprehensive expansion of the sales tax base in a short period of time runs the risk that administrative resources will be overwhelmed.

Policymakers in most states appear to have decided that these drawbacks of the comprehensive approach outweigh the advantages. While virtually all states have expanded their taxation of services to some extent over the years, only South Dakota did so comprehensively. (Hawaii's and New Mexico's laws were written from the outset to tax virtually all services.)[47] In every other state that has expanded its sales tax base to include more services, policymakers have done so by enumerating a discrete group of new services to tax. Officials apparently have concluded that such an incremental approach facilitates a more deliberative process, in which better balancing of revenue, economic, equity, and administrative goals can occur. For example, if a state has only limited administrative resources at a particular point in time, it can focus them on particular service industries in which concerns about compliance are most acute. Once a state gets retailers in these industries on the tax rolls through intensive education and, if necessary, enforcement efforts, it can move on to other segments of the service economy. Likewise, if increasing revenue is a high priority, states can focus on those services that will generate the biggest revenue "bang" for the tax administration "buck" in the shortest period of time.

Defining Taxable Services under the Incremental Approach

If state legislators decide to expand sales taxation of services by specific enumeration, they must either unambiguously identify the service(s) they wish to tax in the sales tax law or authorize the state tax department to issue regulations fleshing-out the definition. As discussed above, some providers of newly-taxable or newly-invented services will want to avoid having to charge sales tax and will look for every legal opportunity to do so. Regardless of the legislature's intent to tax a particular service, if the statute is ambiguous as to taxability, the state may have to engage in a costly audit and litigation effort to put service providers on the tax rolls.

In considering this issue, a question often arises as to whether it is preferable to write the law/regulation to identify services in broad terms (such as "fees for participant sports") or specifically (such as "admission, equipment rental, and other fees for bowling, batting cages, skiing. . ."). The answer is that states would be well-advised to do both. ("Taxable sales include admission, equipment rental, and other fees for participant sports, which include but are not limited to bowling, batting cages, skiing . . .")

Broad definitions can serve as a good "backstop" for more specific listings that may inadvertently omit a particular service. They can also provide a basis for taxing a newly-invented service until such time as the legislature or tax officials have an opportunity to identify it explicitly. Nonetheless, broad definitions are not sufficient to ensure taxability in the face of a taxpayer determined not to charge sales tax.

In a recent Arizona case, for example, the operator of a tanning salon successfully argued that it was not obligated to charge sales tax as a "lessor of tangible personal property" despite the fact that people who used coin-op washing machines and car washes were subject to sales tax under the same provision of the law. The tanning salon's services were held to be tax-exempt merely because staff could stop customers from spending too much time in a tanning booth and could control the tanning setting.[48]

Similarly, America Online is challenging its obligation to charge Tennessee sales tax on its Internet access service on the grounds that the service does not constitute taxable "telecommunications."[49] Tennessee defines telecommunications as follows:

> (A) "Telecommunication" means communication by electric or electronic transmission of impulses;
> (B) "Telecommunications" includes transmission by or through any media, such as wires, cables, microwaves, radio waves, light waves, or any combination of those or similar media;
> (C) . . . "telecommunications" includes, but is not limited to, all types of telecommunication transmissions, such as telephone service, . . . paging service, and cable television service sold to customers or to others by hotels or motels;

AOL's services include person-to-person communication in the form of online chat and e-mail. Nothing in Tennessee's definition limits telecommunications to voice communication. Finally, one-way transmission of information (another element of AOL's service) is clearly considered telecommunication by virtue of the explicit statements that some cable television and paging services are taxable. Nonetheless, because paragraph (C) does not include a specific reference to "Internet access," AOL believes it has grounds to refuse to charge Tennessee sales tax on its service.

The Tennessee America Online case and the Arizona tanning bed case suggest that states should err on the side of specificity and detail in enumerating taxable services if they want to maximize their ability to obtain compliance with their sales tax laws. Both cases also demonstrate that it is important that legislators explicitly extend their sales tax to new services as soon as possible after they appear in the marketplace. Regardless of whether the service arguably is encompassed in a generic, broad definition of one or more taxable services, a recalcitrant seller will be in a position to argue that since the service was not invented at the time the definition was written the legislature could not have intended to tax it.

One way for states to enumerate taxable services without developing a list from scratch is to reference for tax purposes a standardized list and description of services developed for non-tax purposes. There are two such lists that provide great detail about the service sector — the North American Industry Classification System (NAICS) and the North American Product Classification System (NAPCS).[50] A state wishing to extend its sales tax to enumerated services could do so in the following manner:

> Taxable services include the following services enumerated in the North American Industry Classification System, as described therein, regardless of whether the seller is classified in that industry: NAICS code 5133, Telecommunications; . . . etc..[51]

The advantage of this approach is that it references a carefully-developed, detailed description of what is meant by a particular service. Piggybacking on these descriptions gives sellers of services guidance as to whether what they are selling is taxable and therefore may reduce disputes and litigation.

As noted above, South Dakota's sales tax law declares all services to be taxable unless they are specifically exempted. Nonetheless, to provide additional guidance to taxpayers, its law also takes the approach suggested here and piggybacks on the Standard Industrial Classification System (the precursor to NAICS). It reads, in part, as follows:

> The following services enumerated in the Standard Industrial Classification Manual, 1987, as prepared by the Statistical Policy Division of the Office of Management and Budget, Office of the President, are specifically subject to the tax levied by this chapter: metal mining services (group no. 108); coal mining (major group 12) . . .

The North American Product Classification System is oriented toward describing specific goods and services rather than the industries that provide them, and therefore is a more appropriate reference source for sales tax statutes than NAICS. NAPCS is still under development. Nonetheless, its authors have already prepared detailed, draft descriptions for scores of services provided in several key service industries that could be referenced by a state's sales tax law immediately. References to the remaining services could be brought into state sales tax laws between now and 2007, when the work on service industries is scheduled to be completed.

If Tennessee wished to clarify that Internet access services are subject to its sales tax, for example, it could amend paragraph (C) of its definition of taxable telecommunications cited above to include " 'Internet access –narrowband' and 'Internet access broadband' as defined in codes 1.7.1.1 and 1.7.1.2, respectively, of the North American Product Classification System." The former is described in a way that leaves little doubt that America Online provides this service:

> This service consists of a direct connection to the Internet, both wired and wireless, at speeds not exceeding 64Kbps. The Internet Service Provider (ISP) may also provide free services along with Internet access such as e-mail, space for the customer's web page, tools for simple web page design, chat, technical support, etc.. This service may also include remote access or other types of Internet access and package upgrades such as international roaming, extra e-mail boxes, etc., usually for additional costs to customers.

In addition to taking advantage of careful definitional work, using NAICs or NAPCS to establish the state sales tax base could make it easier to gauge the revenue impact of taxing services; state-by-state data on the dollar volume of sales of services are already categorized by NAICS and will be further categorized by NAPCS when it is completed.

IV. Conclusion

The long-term viability of the sales tax as a key source of revenue for states depends upon the modernization of the sales tax base to encompass the steadily-growing share of purchases represented by services. Fairness also demands that people who prefer to spend their money on services not continue to avoid taxes to which people who prefer to spend their money on goods are subject. Yet in the boom years of the late 1990s, when states generally had more-than-adequate revenue to meet immediate service demands, it was almost impossible politically to change tax structures in a way that imposed tax increases on anyone — no matter how compelling the arguments about equity or long-term fiscal balance.

Times of crisis can also be times of opportunity when it comes to tax reform. The severe fiscal problems states are now experiencing and the attendant search for new sources of revenue may enable state officials to enact sales tax base expansions long advocated by tax experts. Nebraska has already expanded its sales tax base to include a number of additional services. The governors of Kentucky, Nevada, and Ohio proposed new sales taxes on services as part of their budget proposals for Fiscal Year 2004. Official state tax study commissions in Kansas, North Carolina, and Washington have also recommended in recent months serious consideration of taxing more services as a means of improving the fairness of the sales tax and raising additional revenue in both the near term and the long run.

As this report has stressed, expanding the sales taxation of services presents policymakers with numerous choices, each option having advantages, disadvantages, and inherent trade-offs. Taxing health care services, for example, would tap the most rapidly-growing segment of the service economy, but it also would sharply increase the regressivity of the sales tax. Taxes on landscaping and housekeeping services would raise additional revenue from predominantly upper-income households, but they could be difficult to enforce because of the large number of people who provide the services on an informal basis. Expanding the sales tax to a large number of relatively narrow services could raise substantial revenue, but it also could entail integrating a large number of new merchants into the sales tax administration system in a very short period of time. Adding services to the tax base a few at a time can help ensure that the state's tax administration resources are not overwhelmed, but it tends to give a free ride for an extended period of time to newly-invented services — many of which are likely to be consumed by the most affluent segments of the population.

There is no one right approach to managing these tradeoffs. Policymakers will make choices based on their states' revenue needs, administrative resources, equity objectives, and economic structures. With the information from this report and input from interested citizens, businesses, and tax administrators, elected officials should be able to ensure that their sales taxes are on a sound financial footing for the coming decades, are fair, are administrable, and have minimal impacts on market decisions.

APPENDIX 1
POTENTIALLY-TAXABLE SERVICES

H = services primarily purchased by households
H/B = services commonly purchased by households and businesses)

Lawn and garden-related services

H/B Landscaping and gardening
H/B Lawn care (chemical/fertilizer treatment)
H/B Lawn mowing
H/B Lawn installation (soil prep, seeding, sod)
H/B Tree and shrub care (incl. trimming and removal)
H/B Landscape architect services

Pet-related services

H/B Veterinary services (doctors, hospitals)
H Horse boarding and training
H Kennels
H Pet grooming
H Pet sitting/walking services
H Pet training (incl. classes)

Personal transportation and related services and rentals

H/B Charter bus/limo/plane/boat - short-term rentals and long-term leases (with or without driver/pilot/crew)
H/B Car/truck/van/motorcyle/RV/ATV/trailer - short-term rentals and long-term leases (incl. misc. charges)
H/B Bus/train/limo/subway tickets and fares (local, inter-, and intra-state)
H/B Airline tickets (for info. only; sales taxation barred by federal law)
H/B Taxi fares
H/B Personal chauffers services (separate from vehicle rental)
H/B Personal pilots services (separate from plane rental)

Storage and moving services

H/B Auto storage (including fees for long-term garage and parking spaces)
H/B Parking garage fees (short-term)
H/B Personal plane hangaring/parking fees
H Marina services (docking/storage/seasonal removal, etc.)
H Household goods storage (including self-storage fees)
H Fur/clothing storage
H Household goods moving services
H Vehicle transport services (including drive-away)
H/B Delivery/shipping/handling charges (purchased goods)
H/B Packing/crating/shipping charges (outgoing shipping, e.g., gifts)
H Gift wrapping services
H/B Messenger/courier services (personal use)
H/B Private shipping/mailing charges (e.g., FedEx, UPS)
H House/mobile home moving services

Residential utility services

H Electricity
H Natural gas
H Water
H Sewer
H Refuse removal/hauling/dumping

Telecommunications and related services (incl. monthly fees and one-time charges)

H/B	Local telephone service
H/B	Interstate/international telephone service (including calling plan fees)
H/B	Mobile telephone service (incl. monthly fees, airtime charges, roaming charges, long-distance charges)
H/B	Paging service
H/B	Caller ID, call forwarding, voice mail, 3-way/conference calling, and similar enhanced phone services
H/B	Internet access service
H/B	Faxing services
H/B	DSL/ISDN service
H	Prepaid telephone calling cards

Financial and insurance services

H/B	Service charges of banking institutions (miscellaneous)
H/B	Safe deposit box rental charges
H	Bill paying services (fee and commission)
H	Investment counseling/financial planning/portfolio management
H/B	Mutual fund management fees
H/B	Credit and debit card fees (incl. annual membership and usage fees)
H/B	Stock brokerage fees/commissions
H/B	Insurance services (life, real property, auto, etc.)
H/B	Imputed brokerage service value of loans and deposits in depository institutions
H	Fees/commissions for check cashing, money orders, travelers checks, money wiring

Personal care services

H	Hair care
H	Hair removal
H	Nail care
H	Day spa services (facials, makeovers, etc.)
H	Massage services
H	Tanning parlors
H	Weight loss salons and counseling
H	Tattoo and piercing services

Miscellaneous personal services

H	Dating services
H	Personals advertising
H	Miscellaneous advertising for personal purposes (e.g., items for sale, positions wanted)
H	Household errand/"personal shopper"/gift consulting/management consulting services
H	Child day care services
H	Adult day care services
H	Baby-sitting services (casual)
H/B	Photocopying/printing services
H	Taxidermy services
H	Custom butchering services
H/B	Bodyguard services
H	Escort services

Home cleaning and maintenance services

H	General house cleaning services
H/B	Carpet cleaning services
H/B	Window cleaning services
H/B	Floor cleaning services

H/B Upholstery/furniture cleaning services
H Swimming pool/hot tub cleaning and maintenance services
H Septic maintenance services
Ductwork cleaning services
H Gutter cleaning services
H/B Snow removal services
H Chimney cleaning services
H/B HVAC maintenance services
H Radon and other home environmental testing services
H/B Pest control services
H Condominium/co-op maintenance fees
H Water softening/conditioning services
H/B Interior decorating and design services
H Home security system consulting, installation, and monitoring
H Closet/storage design consulting services

Clothing-related services

H Diaper service
H Laundry and dry cleaning and pressing services, coin-operated
H Laundry and dry cleaning and pressing services, non-coin-operated
H Shoe repair
H Shoe shining and dyeing
H Alterations, repairs, dyeing, and imprinting of clothing and accessories
H Original tailoring of clothing
H Jewelry repair/cleaning/custom design and fabrication

Education-related services

H Personal instruction (formal classes and one-on-one; see separate list for examples)
H School and university tuition, room and board charges, student fees
H College and private school admission and financial aid counseling
H Test preparation classes
H Private tutoring services
H Private testing services
H Summer camp tuition and fees

Miscellaneous professional services

H Funeral and related services
H/B Accounting/tax preparation
H/B Legal services (wills, estate planning, accident defense, etc.)
H/B Notary services
H/B Private investigator services
H/B Computer consulting/trouble-shooting/data restoration services
H Personal property appraisal services
H Art conservation/restoration services to individuals
H Art/antique collecting advisory and brokerage services
H Commissions on auction purchases/sales (brokerage service)
H Career counseling and resume preparation services
H Debt counseling services
H/B Commercial art, graphic design, calligraphy, printing services (e.g., resume and invitations)
H Personal/professional coaching services

Admissions/amusements/recreation/travel-related services

H Pari-mutuel racing events
H Amusement parks and fairs - admissions, rides, and games

H Admission charges/fees for participant sporting/game facilities (see separate list)
H Coin-operated mechanical amusements (video games, pinball, karaoke, etc.)
H Admissions to school and college sports events (incl. season tickets, "skybox" rentals, etc.)
H Admissions to professional sports events (incl. season tickets, "skybox" rentals, etc.)
H Admissions to movies
H Admissions to cultural events/venues (see separate list)
H Admissions to boat, car, computer, craft, etc. shows
H Lottery tickets
H Other gambling admission and misc. charges
H Health club memberships and fees
H Recreational/scenic transportation (see separate list)
H Memberships (dues, initiation fees, etc.) in sporting clubs and teams (tennis, golf, swimming, baseball, etc.)
H Memberships (dues, initiation fees, etc.) in book and music clubs
H Misc. memberships (dues, initiation fees, etc.) in sororities, neighborhood assns., social clubs, AARP, etc.
H Memberships in buying clubs and coops (e.g., Costco)
H Cable/satellite TV and radio (monthly, pay-per-view, installation, and misc. fees)
H Ticket broker services
H Fees for online gaming, entertain. and info. services and downloadable "digital goods"(see separate list)
H 900 number telephone information and entertainment services
H Services of DJs, musical performers/bands, dancers, other performers for adults
H Services of childrens' performers (clowns, magicians, entertainers, puppeteers, storytellers, etc.)
H Psychic/fortune teller/astrologer services
H Admission fees/cover charges for nightclubs and bars
H/B Services of photographer/videographers (studios and traveling)
H/B Photo finishing
H Media conversion services (e.g., videotape to DVD)
H/B Wedding/party/event planning services
H/B Catering services
H/B Services of private party waiters, bartenders, etc.
H/B Hotel/motel/inn/cabin room rentals
H Complementary meals and hotel rooms at gambling casinos
H Campground and RV park rental charges
H/B Services of travel agents (fees and commissions)
H Services of tour operators (fees and commissions)
H/B Reservation services
H Services of waiters compensated through tips
H Served meals/prepared foods (restaurants, takeout, street vendors, etc.)

Personal property leases and rentals (other than vehicles)

H Musical instruments
H Sporting goods (skis, bicycles, camping equipment, etc.)
H/B Hand and power tools
H/B Gardening tools and equipment
H Tables/chairs/dishes/party-related equipment and appliances
H Dance floors, party tents, "moon bounces," etc.
H Furniture, appliances, home electronics
H/B Computers and peripherals
H Miscellaneous personal property rentals
H Luggage cart rentals at public transit facilities
H Tuxedo/clothing/uniform/costume rentals
H Video tape/DVD/video game rentals
H VCR/DVD/Video game equipment rentals

Misc. repair/installation/fabrication services (other than residences, vehicles, & clothing)

H Furniture and upholstery repair and refinishing
H Appliance repair (kitchen, laundry, vacuum, etc.)
H Home entertainment equipment repair
H Sporting goods repair (e.g., racket re-stringing, bike, gun repair)
H/B Computer repair, hardware upgrading, maintenance
H Camera and video equipment repair
H Musical instrument repair
H Piano tuning
H Sharpening services
H Watch/clock repair
H Picture/artwork framing
H Product assembly/installation services (e.g., furniture, jungle gyms, gas grills, computers, stereo systems)
H Service/extended warranty contracts on personal property
H Custom fabrication services (furniture, cabinets, shelving, window treatments, pillows, sporting goods, etc.)

Medical and related services

H Services of doctors and dentists
H Home nursing services
H Medical testing services
H Psychologist/social work/counseling services
H Optometrists
H Nutritionists/dieticians
H Occupational/physical/massage/speech therapy
H Alternative medicine practioners (e.g., accupuncture, chiropractors)
H Hospital services
H Nursing home services
H Specialized facilities (substance abuse, hospice, dialysis, etc.)
H Nursing home/elder care consultants
H Rent/fees for assisted living facilities
H Rental of medical equipment for home use

Vehicle repair and maintenance services

H/B Auto/motorcycle/RV/ATV repair and maintenance services (engine, transmission, body, tire, etc.)
H/B Boat repair and maintenance services
H/B Airplane repair and maintenance services
H/B Auto/boat/plane cleaning and waxing services
H/B Auto washing and waxing (coin op)
H/B Auto and boat road service, towing, and removal and disposal of wrecked vehicles
H/B Auto/boat/plane rustproofing, painting, other exterior maintenance and customization
H Car audio installation and repair
H/B Auto locksmith services

Residential construction/renovation/repair services

H Locksmith services
H Architectural services
H Consulting engineer services
H Gross charges of a general contractor for labor or for total job
H Skilled trades services (original construction, renovation, and repair; see separate list)
H Basement waterproofing services
H Floor refinishing
H Site excavation and grading
H Well drilling and maintenance
H Rental of construction equipment

Housing and real estate-related services

H Real estate agent fees/commissions (buyers’ and sellers’ agents)
H Real estate title search services
H Real estate appraisal services
H Real estate surveying services
H Real estate inspection services
H Real estate advertising
H Escrow agent services
H Apartment search and roommate matching services
H Loan "points", lock-in fees, other loan-origination fees
H Residential rentals
H Trailer park site rentals

Examples of personal instruction (formal classes and one-on-one)

Musical instruments/voice
Dance
Yoga, aerobics, etc.
Personal trainers
Ceramics/painting/sculpture/crafts
Cooking
Woodworking
Auto repair
Driving
Sailing
Flying
Sports (e.g., golf, tennis, fencing, martial arts)
Computer and computer software use
Misc. adult-education-type courses (investing, retirement planning, public speaking, travel, etc.)

Examples of cultural events/venues for which admission might be charged

Theater, music, dance, ice show, circus, etc. performances
Museums (public and private)
Historic houses and gardens
Natural sites and parks
Guided tours/walks

Examples of participant sports/game facilities/services for which admission fees may be charged

Golf (courses, driving ranges, miniature)
Batting cages
Climbing walls
Skating rinks
Shooting ranges
Horse stables/pony rides
River rafting
Tennis courts
Squash and racketball courts
Bungie-jumping
Ski lifts
Swimming pools
Sky diving
Parasailing
Fishing charter boats
Services of hunting/fishing/climbing guides
Bowling alleys
Billiards parlors
Laser tag
Paintball
Go-carts

Examples of recreational/sight-seeing transportation

Train rides
Boat rides
Chair lifts/gondolas
Bus/limo/van/jeep rides
Dinner cruises
Helicopter, balloon, plane, glider rides

Examples of online entertainment and information services

Online gaming services
Online music access services
Downloadable music and video
Adult content sites
Gambling sites
Online newspaper and magazine subscriptions and archives
Online databases and information (financial, current stock prices, genealogy, etc.)
Downloadable software
Downloadable articles (pay-per-view)

Examples of skilled residential construction/renovation/repair services

Carpentry
Painting/staining/deck treatment, etc.
Wallpapering
Plumbing
Drywall/plaster
Masonry/cement/stucco/driveway
Roofing
Electrical
Heating and air conditioning
Flooring installation
Custom cabinetry making/installation
Swimming pool
Fencing
Tile/marble/countertops

Notes

[1] Federation of Tax Administrators, *Sales Taxation of Services, 1996 Update*, April 1997. Available at http://www.taxadmin.org/fta/pub/services/services.html. There have been some changes in state taxation of services since 1996, but most of them are new exemptions, not tax base expansions. FTA has begun compiling a list of changes in sales taxation of services since 1996 at the indicated Web site.

[2] In a majority of states with sales taxes, some kinds of local governments are also authorized to impose them. In most instances, the local sales tax base — the group of items subject to tax — is substantially similar or identical to the state sales tax base. In the interest of readability, this report will refer to "state" sales taxes, but nearly all of the discussion applies to local sales taxes as well (including the sales tax of the District of Columbia).

[3] Texas estimates that it lost $623 million in sales tax revenue in FY01 by failing to tax new residential construction labor, residential repair and remodeling, barber and beauty services, auto maintenance and repair, and car washes. Source: *Tax Exemptions and Tax Incidence Report*, available at www.window.state.tx.us/taxinfo/incidence/table6.html. The estimated revenue loss from Michigan's failure to tax services is in the *Executive Budget Tax Expenditure Appendix, Fiscal Year 2003*, p. 44.

[4] The remaining household consumption not accounted for in these figures is composed of housing and food for use at home. The source of the data is the personal consumption expenditures component of the Gross Domestic Product Accounts published by the Commerce Department.

[5] Such generalized taxation of services would have to exempt health care services for this statement to be fully accurate, however. Research suggests that imposing sales taxes on health care services in addition to most other household services would increase the regressivity of the sales tax.

[6] Information about NAICS is available at www.census.gov/epcd/www/naics.html. Information about NAPCS is available at www.census.gov/eos/www/napcs/napcs.htm.

[7] An auditor could easily estimate the tax a retailer should have remitted in a particular period by adding up the invoices for the goods the retailer purchased for resale, adding an industry standard mark-up, and then calculating tax on this estimated sales figure. If a retailer were tempted to engage in substantial cheating — selling items without charging the tax or pocketing the tax collected from customers — he knew he would have to explain the discrepancy between his sales figure and that estimated by the auditor.

[8] Most state sales taxes enacted during the Depression were levied almost exclusively on retail sales of goods for the reasons described in this paragraph. It is worth noting, however, that the two state sales taxes with the broadest coverage of services to this day — those of Hawaii and New Mexico — were also enacted during this period.

[9] Housing represents a special type of consumption that falls somewhere between a good and a service. On the one hand, the purchase of a newly-constructed house might be viewed as nothing more than the purchase of a very large, expensive, durable good. On the other hand, the rental of that same house from its owner arguably is closer to the purchase of the "shelter services" provided by the dwelling for a defined period of time. Disparate sales tax treatment of owner-occupied and rental housing would have profound equity and economic implications, since both represent consumption of housing and are substitutes for one another. Moreover, repairs and renovations of dwellings clearly are services that might potentially be subjected to sales tax, and disparate treatment of such services and the initial purchase of the dwelling also has equity implications. For these reasons, and because housing is considered a service in the National Income and Product Accounts, its sales tax treatment is discussed occasionally in this report.

[10] "Tax avoidance" refers to actions taken to avoid paying a tax that are legal. If a state began applying its sales tax to haircuts and an individual decided to avoid the tax by crossing into another state that did not tax haircuts to have his hair cut, that action would be tax avoidance. If a dry cleaner tried to avoid charging sales tax by not ringing up all its sales on its cash register, that would be illegal tax evasion. It sometimes requires litigation to determine whether failure to comply with a tax constitutes tax evasion or not, for example, when a sales tax statute is ambiguous as to whether it applies to a particular service.

[11] Data from the 1997 economic census of service industries can be accessed at www.census.gov/epcd/www/ec97stat.htm.

[12] While it seems unlikely that states would seek to impose their sales taxes on monthly rent or mortgage payments, it would be feasible for states to tax labor charges for the construction, renovation, and repair of residential housing. The GDP data for housing consumption do not permit a break-out of amounts spent on such labor, and so housing is excluded entirely from the revenue estimates developed in this section. The exclusion of residential construction labor means that the estimated revenue yield from taxing services shown in Table 1 is conservative.

[13] This methodology implicitly assumes that the share of total personal income devoted to consuming "readily-taxable services" is the same in every state. This is unlikely to be true for at least two reasons. First, states in which the average household is relatively affluent are likely to devote a below-average share of personal income to consumption of "readily-taxable services" because households will save rather than consume above-average shares of income. Second, states with relatively high housing costs or health care expenditures (for example, because of a disproportionately elderly population) will have less discretionary income to devote to buying "readily-taxable services."

The goal of Table 1 is to develop an order-of-magnitude estimate for sales taxation of services, and the implicit assumption of equal shares of personal consumption devoted to purchases of services seems consistent with that objective. However, the shortcomings of the assumption should be kept in mind.

[14] The FY01 sales tax collections data reported in Column 5 have been generated by Professor John Mikesell of Indiana University by adjusting Census Bureau data. The state sales tax collections data published by the Census Bureau itself have certain methodological shortcomings that make them unsuitable for a calculation like that in the right-most column of Table 1. Professor Mikesell's adjustments to the Census Bureau data are described in John L. Mikesell, "Retail Sales Taxes, 1999-2001: The Recession Hits," *State Tax Notes*, February 10, 2003, pp. 489-99; this article is also the source of the data in Column 5.

[15] Table 2 has updated the results of the 1996 FTA survey with information recently supplied to FTA by the states and posted on its Web site at http://www.taxadmin.org/fta/pub/services/state1.html. Not all states have provided updates, so it is possible that Table 2 is not a completely accurate reflection of current state taxation of the enumerated services.

[16] Revenue foregone from the failure of a state to tax certain services is usually included in the state's "tax expenditure report" or "tax expenditure budget." The reports of Idaho, Michigan, Minnesota, Missouri, Nebraska, New York, Pennsylvania, Tennessee, Texas, and Wisconsin all include somewhat-detailed estimates of the revenue foregone from the exemption of services from the sales tax. The tax expenditure reports of most of these states are available on the World Wide Web and can be linked to at www.taxpolicycenter.org/TaxFacts/state/statelinks.cfm.

[17] *Tax Exemptions and Tax Incidence Report*, available at www.window.state.tx.us/taxinfo/incidence/table6.html.

[18] *Executive Budget Tax Expenditure Appendix, Fiscal Year 2003*, p. 44.

[19] Office of Governor Paul E. Patton, *Securing Kentucky's Future*, January 2003, p. 28.

[20] The sources for the sales tax data in this paragraph are: John L. Mikesell, "Retail Sales Taxes, 1999-2001: The Recession Hits," *State Tax Notes*, February 10, 2003; John L. Mikesell, "State Sales Taxation: A Quarter-century Retrospective," *State Tax Notes*, June 30, 1997; and John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, Second Edition (Washington: Urban Institute Press), 1994, pp. 46-51.

[21] The erosion of the state sales tax base arising from the shift toward purchases of services by households appears to have been reinforced by a similar trend in the business sector of the economy. Business purchases from other businesses are also frequently subject to sales tax. Federal Reserve Bank of Boston economist Robert Tannenwald has conducted a careful analysis of recent changes in the household versus business shares of sales transactions that states could potentially subject to sales taxation. He found that business purchases of what he termed "tax-preferred items" — many of which are untaxed purchases of services by businesses in the service sector of the economy from

other service-sector businesses — rose from 18.4 percent of total business purchases in 1977 to 30.2 percent of business purchases in 1997. See: Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, Issue No. 4, 2001, Table 1, p. 34.

[22] See Note 4.

[23] Robert A. Bohm and Eleanor D. Craig, "Recent Sales Tax Trends: Services as a Point of Departure," in *Proceedings* of the 1993 Annual Meeting of the National Tax Association, pp. 54-62.

[24] Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, Issue No. 4, 2001, pp. 33-4. Tannenwald raises this issue but does not appear to agree with the hypothesis state here; he suggests that goods costs are likely to *rise* as workers in developing countries demand wages comparable to those earned by workers in the United States.

[25] In a December 2003 survey by BizRate.com, 48 percent of online shoppers admitted to purchasing online, in part, to avoid paying sales tax. Leslie Walker, "Net Shoppers Making a Little Go a Long Way," *Washington Post*, December 12, 2002. Wyatt Buchanan, "Californians Duck Sales Tax by Shopping Across Border in Oregon," *San Francisco Chronicle*, January 14, 2003.

[26] It might be argued that going from a zero percent sales tax on services to, say, an eight percent rate, is likely to generate more sales tax avoidance than increasing an existing sales tax on goods by another percentage point. There is some validity to this argument, but, in general, the sales tax levied on many services purchased by households either cannot be easily avoided or likely would be too small to stimulate tax avoidance behavior. For example, one cannot take one's house out of state to have the plumbing repaired, and it seems unlikely that many people would drive very far to avoid a couple of dollars of sales tax imposed on a haircut. As discussed on page 25, however, many expensive services purchased by businesses can be avoided/evaded by purchasing them across state lines, which is an argument for generally foregoing sales taxation of business-to-business sales of services. Some big-ticket purchases of services by households, such as auto repair, might be purchased from an out-of-state provider in a nearby state not taxing the service. Given the virtual impossibility of imposing a compensating use tax on such a transaction, a state contemplating taxing such a service in a situation in which it is not taxed in a nearby state either would have to abandon the attempt or accept some degree of revenue leakage.

[27] Not all tax experts agree with this hypothesis, with some justification. Many services, such as entertainment services and home renovations, are luxury purchases that are probably just as likely to be deferred in economic hard times as are purchases of consumer durables.

[28] Richard F. Dye and Therese J. McGuire, "Expanding the Sales Tax Base: Implications for Growth and Stability," in William F. Fox, *Sales Taxation: Critical Issues in Policy and Administration*, Praeger Publishers, 1992, Table 12.2, p. 173.

[29] Robert S. McIntyre, et. al, *Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States*, Second Edition, Institute on Taxation and Economic Policy, January 2003. The figures cited combine general sales taxes imposed on household purchases and sales taxes on business inputs passed through to households in the price of items households buy.

[30] Lung-Fai Wong, Joel Michael, and Doug Wilson, "The Distributive Effect of Expanding the Sales Tax," *Public Finance Quarterly*, October 1990, pp. 465-479.

[31] John J. Siegfried and Paul A. Smith, "The Distributional Effects of a Sales Tax on Services," *National Tax Journal*, March 1991, pp. 41-53.

[32] The same calculations using South Dakota (which also taxes services extensively) and Alabama as a matched pair led to an almost identical result.

[33] Summarizing existing research, Professor John Mikesell, one of the nation's leading experts on state sales taxes, states: "[I]t is not clear that the taxation of services makes the [sales] tax less regressive. Use of most such services

does not in fact appear to be significantly progressive by income level." John Mikesell and John J. Due, *Sales Taxation*, Second Edition (Washington, DC: Urban Institute Press) 1994, p. 92.

[34] "Did Distortionary Sales Taxation Contribute to the Growth of the Service Sector?" *National Tax Journal*, March 2000, pp. 125-142.

[35] Several of these examples are identified in Laird Graeser, *Sales Taxation of Services: A Review of the Issues*, unpublished paper, Federation of Tax Administrators, July 1990.

[36] Except for a few states whose taxes were grandfathered, states are temporarily barred from imposing sales taxes on Internet access services by the federal Internet Tax Freedom Act.

[37] No suggestion is implied that Internet sellers or sellers on the other side of a state border are inherently less efficient or charge higher prices than in-state merchants. The point is that the tax "wedge" created by the sales tax can lead to situations in which consumers have an incentive to buy from less-efficient and more-expensive cross-border sellers, and that economic inefficiency results when this occurs.

[38] Graeser, *Sales Taxation of Services* (see Note 35), p. 15.

[39] Nearly all states with sales taxes impose them on three transactions that might be labeled sales of "quasi" services: sales of restaurant and other prepared meals, rentals of "tangible personal property" like videotapes, and rentals of hotel rooms and other "transient accommodations."

[40] Pyramiding is sometimes described as imposing a "tax on a tax." This does occur when a business tries to recoup the sales tax paid on an input by passing this cost into the final selling price of an item that is itself subject to sales tax. However, that phenomenon represents only a small part of the pyramiding problem. The bulk of the pyramiding is associated with taxing inputs twice.

[41] Raymond J. Ring, Jr., "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, March 1999, pp. 79-90.

[42] A 1993 study by economists Frederick W. Derrick and Charles E. Scott found that if the Maryland sales tax imposed on business inputs were passed on to consumers (which they assumed to be the case), it would be both higher and more regressive than the direct sales tax paid on consumer purchases. Direct sales taxes paid constituted 3.48 percent of income for the bottom 20 percent of the income distribution, 3.35 times the 1.04 percent of income paid by the top 20 percent. However, passed-through taxes on business inputs were 5.67 percent of income for the bottom quintile, 4.08 times the 1.39 percent of income devoted to such taxes by the top quintile. Derrick and Scott found that the passed-through taxes were more regressive than the direct taxes because they were imposed on many inputs purchased by businesses in the food, health care, and utility industries, the output of which is exempt from direct Maryland sales taxation. See: "Businesses and the Incidence of Sales and Use Taxes," *Public Finance Quarterly*, April 1993, pp. 218-21. A study of the short-lived Florida sales tax on services found, in contrast, that taxation of business-to-business sales of services contained in that package actually somewhat reduced the regressivity of the state's sales tax. See the paper by Siegfried and Smith cited in note 31, p. 48.

[43] It is worth noting that in the two states in which substantial taxation of these kinds of services was initiated — Florida in 1987 and Massachusetts in 1991 — the taxes were repealed very quickly due to fierce business opposition and difficulties in implementation.

[44] Julia Angwin and Nick Wingfield, "AOL Brings Online Music to the Masses, for a Price," *Wall Street Journal*, February 26, 2003.

[45] See www.coachfederation.org, and Jeffrey Zaslow, "Personal Life Coaches Seek Advice from Other Coaches," *Wall Street Journal*, November 5, 2002.

[46] South Dakota's statute goes on to enumerate specific services that it considers to be taxable, but makes clear that all services are taxable and the list is only to be used as a guide.

[47] John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, Second Edition (Washington, D.C.: Urban Institute Press) 1994, p. 89.

[48] *Energy Squared* v. *Arizona Department of Revenue*, Arizona Court of Appeals, October 24, 2002.

[49] *America Online* v. *Tennessee*, Plaintiff's Response to Defendant's Statement of Additional Material Facts, January 2001, paragraphs 43 and 46. AOL is challenging its obligation to charge Tennessee sales tax on its monthly fees on several grounds in addition to asserting that the service does not satisfy Tennessee's definition of taxable telecommunications. In a related case, a Tennessee trial court has held that Internet access services do not, in fact, satisfy the state's definition of taxable telecommunications. See: *Prodigy Services Corporation* vs. *Johnson*, March 18, 2002. This decision currently is on appeal.

[50] See Note 6.

[51] The modifier, "regardless of whether the seller is classified in that industry" is needed if the state references NAICS. NAICS is oriented toward classifying industries, not specific services, and it is possible for a seller to be classified in a particular industry that describes its predominant activity yet also sell a service that is the core business of another NAICS industry. For example, auto dealerships, NAICS industry 4411, and gasoline stations, NAICS industry 447, do the same kinds of auto repairs as do auto repair and maintenance providers, NAICS industry 8111.