ITEP Institute on Taxation and Economic Policy

TALKING TAXES

Should Sales Taxes Apply to Services?

General sales taxes are an important revenue source for state governments, accounting for close to a quarter of state tax collections nationwide. But these taxes have a potentially damaging structural flaw: the tax typically applies to most sales of goods, such as books and computers, but exempts services such as haircuts and car repairs. This omission is not the result of conscious policy choices, but a historical accident: when most state sales taxes were enacted in the 1930s, services were a relatively small part of consumer spending. In recent years, however, spending on services has skyrocketed: in 2007, services represented almost 60 percent of personal consumption nationally. Few states have successfully adapted to this change in consumption: only Hawaii, New Mexico, and South Dakota tax services comprehensively, and the Federation of Tax Administrators estimates that only nine states tax more than half of the services that are potentially taxable. This policy brief surveys arguments in favor of taxing services—and assesses potential pitfalls in attempts to tax services.

Taxing Services = A Fairer Tax

Sales taxes generally create two types of unfairness in the tax code–and taxing services can help eliminate each of them. First, sales taxes are *regressive*, requiring low-income taxpayers to pay more of their income in sales tax than wealthier taxpayers. Second, sales taxes generally include a wide variety of special exemptions, which often discriminate between similar taxpayers in ways that are not defensible from a tax fairness standpoint. Exemptions for services are a good example of this sort of unfairness: exempting services discriminates against individuals who consume more goods than services. The first type of unfairness is called *vertical equity* because it compares the treatment of taxpayers at different income levels; the second type is called *horizontal equity* because it compares the treatment of taxpayers at the same income level.

Taxing services can help to reduce each of these problems. Expanding the base to include personal services results is a slightly less regressive sales tax compared to a goods based tax because many of these services are consumed disproportionately by wealthier taxpayers. And treating consumer services the same way as consumer goods will eliminate discrimination in the tax code between goods-consuming and service-consuming taxpayers.

Taxing Services Will Not Eliminate Unfairness

However, the fairness gains from taxing services are likely to be limited in practice. First, low-income taxpayers spend more of their income than do wealthier taxpayers, who are more likely to be able to save some income. No expansion of the tax base is likely to change this basic relationship between consumption and income. Second, the impact of taxing services on tax fairness can vary depending on which services are taxed. Taxing services such as housing, utilities, and other necessities can actually make the sales tax more regressive because these services are basic staples of consumer spending, not high-end luxuries. And it may be politically more difficult to tax services consumed by the wealthy than to tax services consumed by low-income taxpayers.

Taxing services can also have a negative impact on fairness if the services taxed include services consumed by businesses. Economists agree that items purchased by

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wholesalers for resale, and items purchased by businesses for use in producing other products, should not be taxed. Legal and accounting services are examples of "business to business" transactions. Taxing these services will make sales taxes more unfair because "business to business" sales taxes are ultimately passed through to consumers in the form of higher prices. These passed-through taxes are invisible to the consumer, and have unpredictable effects on tax fairness (since the amount passed through depends on the number of stages of production that were taxed). For this reason, sales tax base expansion efforts should focus on services that are consumed by individuals rather than businesses.

When properly done, expanding the sales tax base to include services is simply good tax policy: taxing services can make sales taxes less regressive, less discriminatory and more responsive to economic growth.

Taxing Services = Higher Revenue and Faster Growth

As a practical matter, state policymakers see taxing services as a desirable policy option because it allows states to increase tax revenues in the short run without increasing tax rates. Expanding the tax base to include more services will increase the amount of taxes collected for each percentage point of the sales tax rate—a critical consideration in states where increasing tax rates is politically difficult. But taxing services will also pay long-term dividends: as consumers spend more of their income on services, states taxing these services will see faster growth in sales tax revenues. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of consumption will be offset by gains in another area. In other words, adding services to the tax base helps achieve adequate revenues in both the short run and the long run— and will be satisfactory to both political leaders and economists.

Approaches to Taxing Services

Lawmakers seeking to expand the sales tax base face three policy choices: which services to tax, whether or not to couple any base expansion with a cut in the tax rate, and whether to provide targeted tax relief to partially offset this regressive tax hike.

Expanding the sales tax base will increase tax revenues if no other changes are made. However, if raising new revenue is not an immediate goal, combining a sales tax base expansion with a tax rate reduction can be an appropriate step. A "revenue-neutral" tax change of this kind, which expands the tax base and reduces the sales tax rate to leave total sales tax collections unchanged, will likely result in higher tax revenues over the long run, since consumption of services generally grows faster than consumption of goods.

One way to reduce the regressive impact of taxing services is a targeted tax credit. Twenty-three states and the District of Columbia now allow an Earned Income Tax Credit, designed to reduce taxes on low-income working families, and a few states allow sales tax credits, designed to offset part of the sales tax liability on low-income taxpayers. Either approach will provide targeted tax relief to those most affected by regressive sales taxes, at a relatively low cost to the state. *(ITEP Policy Brief #14 discusses options for sales tax relief, and Policy Brief #15 discusses the Earned Income Tax Credit.)*

Conclusion

Taxing services is attractive to policy makers because it allows revenue-raising without highly-visible increases in tax rates, and is attractive for consumers because it avoids discriminating between taxpayers. When properly done, expanding the tax base is simply good policy: taxing services can make sales taxes less regressive, less discriminatory and more responsive to economic growth. But sales taxes remain regressive—which means that provisions for low-income tax relief through an Earned Income Tax Credit or sales tax credit may be appropriate.

To find out more about this issue, contact ITEP at (202) 299-1066