Testimony to the South Carolina Tax Realignment Commission on Sales Taxes on Services and Internet Sales

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The Nature of the Service Sector

Purchases of services by households, business firms, nonprofit entities and governments accounted for around 57 percent of the nation's Gross Domestic Product in 2008. "Services" is a catch-all term that covers a great variety of purchases.

For consumers, this category includes such items as utilities—gas, electricity, water, and telecommunications—lease or rental of housing, cars, and tangible goods like furniture, tools and equipment; education and recreation; household services such as cleaning, yard maintenance, pet care, pest control, painting, and repairs to household equipment; and transportation by car or taxi, bus or subway, train or airplane. Many services purchased by households are linked to the purchase of tangible goods, such as auto repair, catering, and computer installation, maintenance, instruction and software. In general, the purchase of services represents a larger share of consumer spending in higher income households.

Business firms are also major users of services, including education and training, installation and maintenance of business equipment, transportation of raw materials and finished products, conferences and catered events, and outsourced services such as accounting and human resource management. Major categories of services in the national income accounts include transportation and utilities, information and communications services, financial services, professional and business services, education and health services, and leisure services.

In South Carolina, the service sector accounted for about 47 percent of state GDP in 2008. South Carolina has a smaller service sector than many other states. Financial services are the largest single category nationally and in South Carolina. Only transportation and leisure services, reflecting tourism and a growing elderly population, represent a larger share of GDP in South Carolina than in the nation as a whole.

Forty five states and the District of Columbia levy retail sales taxes. Most of them tax only a limited number of services, with the exception of Hawaii, New Mexico, South Dakota, and West Virginia, which extend the tax to a broad range of services. Some services that are not covered by the general retail sales tax are subject to a separate excise tax, such as the tax on admissions and amusements in South Carolina.

The service sector has grown more rapidly than the tangible goods production and distribution sectors, which includes retailers. From 1970 to 2007, services have grown from about 30 percent to about 45 percent of household consumption, while at the same time the typical sales tax base as a share of household consumption has fallen from just under 40 percent to slightly over 30 percent.[1] Part of that growth is the shift to services among higher-income households. But sales taxes on tangible goods have actually contributed to the growth of the service sector, which is largely untaxed. A study by two economists published in 2000 in the *National Tax Journal* finds that retail sales taxes in general, and increases in retail sales tax rates, have contributed to the shift in consumption away from taxed tangible goods and toward untaxed services. [2]

Consumer Services versus Business Services

Unlike some other states, South Carolina exempts few if any purchasers. Exemptions are defined in terms of the nature of the good or service being purchased rather than whether the purchaser is a household, business firm, nonprofit entity or governmental entity. This choice simplifies the administration of the tax but disadvantages business firms whose activities involve a high proportion of purchases subject to the sales tax. A broader base would discriminate less among different types of businesses.

According to several studies, business firms pay about 40 to 45 percent of retail sales taxes. Business firms are also consumers of a variety of services. Extending the retail sales taxes to cover more services would affect business firms as well as other purchasers, but the selection of services to tax could be a factor in how much of the tax falls on business firms.

Many business services are purchased by nonprofits. Nonprofits are frequently exempt from property taxation, so expanding the taxation of business services will generate some revenue from nonprofits, which use public services, especially at the local level (police and fire protection, sanitation, roads, etc.).

Services that are Currently Taxed in South Carolina

Although the retail sales tax is primarily levied on tangible goods, there are certain services that are subject to sales tax in South Carolina. They include laundry and dry cleaning services, some communications services, electricity, restaurant meals (which combine tangible goods with services), and leases of some personal property (but not automobiles). Maintenance contracts on production machinery are subject to sales tax, but not on other machinery and equipment, which includes computers, copiers, and other home and business office equipment and home

[1] Michael Maserov, Center on Budget and Policy Priorities, Washington, DC, December 1, 2009 presentation to the Interim Joint House and Senate Finance committees of the North Carolina General Assembly.

[2] Merriman, David and Mark Skidmore, "Did Distortionary Sales Taxes Contribute to the Growth of the Service Sector?" *National Tax Journal,* March 2000, pp. 125-142.

appliances. This distinction shifts more of the sales tax burden to traditional manufacturing as opposed to households, nonprofits, government agencies and service-type businesses. Maintenance contracts offer a particularly good candidate for expansion of the sales tax base.

Admissions and amusements are not subject to a sales tax but are subject to a separate excise tax at a lower rate. This last category could be converted to a sales tax that would be subject to the same state rate as well as local option sales taxes.

Services Commonly Taxed in Other States

The Federation of Tax Administrators issued a report on taxation of services in 2005.[3] A total of 168 different services were subject to sales tax in one or more states. The states with the highest number of taxed services were Hawaii (160), Washington (157), New Mexico (156), South Dakota (146), District of Columbia (143), and West Virginia (110). In Hawaii, New Mexico, and South Dakota, all services are taxed unless specifically exempt. South Carolina, with 34 services, ranked 28th out of 45 states and the District of Columbia in the number of services subject to tax.

According to the *Sales and Use Tax Answer Book,*[4] among the more common services subject to retail sales taxes are

- Transportation (including rental cars, airline departures, etc.)
- Household services (such as landscaping and lawn care, cleaning, pest control)
- Automotive services: repair, cleaning, etc. (20 states plus the District of Columbia tax repair services)
- Newspapers (some states consider it a service): taxed in 11 states and the District of Columbia
- Vending machine sales, which fall in that gray area between good and service (36 states and the District of Columbia)
- Transient lodging (taxed in SC)
- Amusements and admissions (subject to a lower excise tax in SC)
- Maintenance and repair services and maintenance contracts or warranty work
- Printing and photography
- Other utilities besides electricity
- Consulting
- Advertising
- Credit reporting
- Employment services
- Parking
- Janitorial services
- Health clubs
- Self-storage
- Telephone answering services

[3] "Are You Being Served?" *Tax Administrator News*, May 2005, p. 34-38.
[4] Kozub, Robert M, James T. Collins and John C. Healy, *Sales and Use Tax Answer Book,* Aspen Publishers, 2001.

What is the Revenue Potential?

There are no direct statistics showing the percentage of sales tax revenue that derives from taxing services in addition to goods. There are a few estimates available for specific categories. For example, in a recent report to the North Carolina General Assembly, it was estimated that taxes on installation and repair of tangible personal property alone would generate $253 million in that state in 2010-11.[5]

However, there are some indications that can be drawn from the experience of the five states that tax the broadest range of services. Table 1 shows the tax rates, sales tax revenue, and population of South Carolina and those five states. Also shown are the revenue per capita per one percent of the sales tax rate, and the revenue as a percent of personal income per one percent of the sales tax rate.

Table 1
State Sales Tax Revenue Comparisons, 2008

	SC	HI	NM	SD	WA	WV
Sales Tax Rate	6%	4%	5%	5%	6.5%	6%
Revenue (billions)	$3.05	$2.62	$1.95	$340	$11.35	$1.11
Population (millions)	4.4	1.3	2.0	0.8	6.6	1.8
Sales Tax Revenue						
Per capita per 1% of tax rate	$114	$509	$197	$85	$264	$103
Percent of personal income, per 1% of tax rate	0.35%	1.2%	0.6%	0.2%	0.76%	0.38%

Source: U.S. Bureau of the Census and author's calculations.

Hawaii is probably an outlier with its very high sales tax revenue because it is an extremely popular tourist destination. South Dakota is an outlier in the opposite direction, a very lightly populated state with only 800,000 people and no significant urban centers. The three states that tax a broad range of services and offer more meaningful comparisons are New Mexico and West Virginia, with a little less than half the population of South Carolina, and Washington, with a population that is 50 percent larger. West Virginia's revenue results are not encouraging, with slightly less revenue per capita and slightly more revenue as a percent of personal income at the same 6 percent rate as South Carolina in 2008. (West Virginia also taxes a significantly smaller range of services than either New Mexico or Washington.)

The other two states offer more encouraging revenue numbers. New Mexico generated 73 percent more revenue per capita from sales taxes per one percent of the sales tax rate than South Carolina in 2008. Revenue as a percent of personal income, also adjusted for the difference in sales tax rates, was 71 percent higher. Washington generated 131 percent more revenue per capita from sales taxes per one percent of the sales tax rate than South Carolina in

[5] Michael Maserov, Center on Budget and Policy Priorities, Washington, DC, December 1, 2009 presentation to the Interim Joint House and Senate Finance committees of the North Carolina General Assembly.

2008. Revenue in Washington as a percent of personal income, also adjusted for the difference in sales tax rates, was 117 percent higher.

Advantages of Taxing Services

There are many advantages to broadening the tax base through increased taxation of services. The biggest advantage is that taxing services makes it possible to generate more revenue at a lower tax rate with a broader tax base. The additional revenue will provide some relief to hard-pressed local governments, which also rely on the sales tax, and help ensure more adequate funding for public education, which depends heavily on sales tax revenue to fund property tax relief.

With expanded coverage of services, the burden of the sales tax could be distributed more fairly, depending on the mix of services taxed. In general, low income households tend to consume a smaller proportion of services. It is difficult to determine whether expanded coverage of services will increase or decrease the share of the sales tax paid by business firms, because it would depend on what services are subject to tax. Broader coverage would also treat consumers more equally when they choose to substitute a good for a service or vice versa (buy a washing machine or use the Laundromat, for example).

Growth of sales tax revenue has lagged behind growth of personal income in South Carolina and nationally. Inclusion of more services in the tax base will bring sales tax revenue growth more in line with growth of personal income.

As indicated earlier, including more services will reduce the distortion of consumer choice that has favored nontaxed services over taxed tangible goods. For a state like South Carolina that still is heavily invested in tangible goods production, broadening the coverage of services reduces the handicap faced by our goods producing industries.

The sales tax is a particularly good tool for generating revenue from the nonprofit sector, which generates no local property tax revenue and very little income tax revenue but does use state and local public services. Nonprofits, including churches, private schools, hospitals, and other charitable organizations, do pay taxes on their purchases of tangible goods in South Carolina, which is not the practice in some other states. Nonprofits are also significant consumers of a variety of services, such as building and equipment maintenance and repair, automotive services, cleaning services, accounting service, landscaping and lawn maintenance services. Also, many nonprofits sell services, such as education and health care, which are not subject to sales tax even with fairly broad coverage of services, so at least some sales tax would be collected.

One current challenge to the sales tax as a state revenue source is internet and catalog sales. Services are less vulnerable to competition from internet and catalog vendors than tangible goods, so a broader coverage of services might add some longer term revenue stability.

Taxes on tourism services are a good way to shift some of the cost of providing public services to nonresidents, who use many of those services during their visits to the state. Focusing on services that are used by transients is a good way to shift that burden, a step that South Carolina has already taken with sales and accommodations taxes on transient accommodations and with local hospitality taxes on restaurant meals. Expanding tourism taxes to transportation is a logical next step.

Drawbacks of Taxing Services

The chief drawback of taxing services is that it will be more expensive for the state to collect and more expensive for vendors to comply, because there are many small service firms, typically smaller than the retailers who sell the bulk of tangible goods. The challenge of bringing many small service providers into the tax system may be mitigated by selecting services to tax that are typically provided by larger firms or services that are provided by firms that also sell tangible goods. Maintenance contracts, for example, are usually sold in conjunction with purchase of tangible goods. Auto repairs already involve sales tax on parts but not labor, so extending coverage to repair services would not increase compliance costs.

While expanding coverage to services will increase long term stability of revenue, in the short run revenue may be more volatile, declining more sharply in recessions and increasingly more rapidly during economic expansions. Many services are considered luxuries that can be cut back when household or business income declines and reinstated when income improves. Revenue stabilization is an issue that the General Assembly is attempting to address in other ways, so this objection is not insurmountable, but it is a relevant consideration.

Proceeding with Caution

Two decades ago, the state of Florida attempted to make a major expansion of sales tax coverage of services. Unfortunately, two of the services they included in the taxable list were legal services and advertising services. Those two groups teamed up to generate a campaign to repeal the expansion of the tax. Today Florida taxes 64 kinds of services, substantially more than South Carolina but ranking only 19th among the 46 sales tax jurisdictions.

There is a lesson from the Florida experience to move more gradually and thoughtfully in the direction of expanded coverage of services in order to avoid active and organized resistance. At the same time, the package needs to be sufficiently broad and diverse so that no single service or cluster of services feels that it is being singled out for additional taxation.

Cross-border shopping to avoid the tax is always a concern of tax administrators. Services are less vulnerable to cross-border shopping because many services are performed on site, but there are some services that can be purchased across state lines, particularly outsourcing of business functions such as payroll and accounting. Twenty of South Carolina's 46 counties border either Georgia or North Carolina.

One place to begin is to explore what services are subject to tax in those two states that are not taxed in South Carolina. Both presently have a limited number of services subject to tax, 36 in Georgia and 30 in North Carolina. However, expanded coverage of services is currently under consideration by the North Carolina General Assembly.

A second area to explore is the purchase of services that accompany tangible goods, because taxes on those services are easier to administer. The mechanism for recording and reporting payments is already in place. Maintenance contracts, repair services, and landscaping services all fit into this category.

South Carolina's sales tax, like that of many states, is a product of an earlier era. Most state sales taxes came into being in the 1930s and 1950s when tangible goods made up a much larger share of spending. As the economy has changed, the base of the sales tax needs to be adjusted to reflect that change. Expanded coverage of services in order to broaden the base and distribute the burden more equitably among taxpayers would represent a significant improvement in our state's tax structure.

Taxing Internet Sales

I have one other sales tax issue I would like to address. Several months ago, you had a speaker address the issue of internet taxation. I would like to underscore the importance of that issue because it is both a revenue issue and an economic development issue.

I have a particular interest in internet taxation because I worked for the U.S. Advisory Commission on Intergovernmental Relations some 25 years ago when I was on sabbatical leave from Clemson University. My primary assignment was to write the definitive study of the issue of taxation of interstate mail order sales. The same issues that were at stake in mail order sales are relevant to the explosive growth of internet sales.

A healthy local retail sector is an important dimension of quality of life that attracts and retains business firms and higher income residents. It also is an important source of local government revenue and local service employment. But in-state retailers—whether downtown or at the mall—compete directly with on-line retailers for customers.

Unlike local retailers, internet vendors are not required to collect and remit sales taxes to state and local governments. As a result, in-state retailers are operating under a 6 percent price disadvantage—7 percent in the 29 counties with local option sales taxes. While internet vendors argue that they have to incur shipping costs, local retailers also have high costs for maintaining a physical facility (including parking) and a local sales staff. There is no reason why we as a state should consent to creating a 6 percent to 7 percent handicap for our retail firms, who also create local jobs and contribute property tax revenue, business license fee revenue, and sales tax revenue to the South Carolina public sector.

The sales tax is a *destination principle* tax. That is, economic theory supports the contention that most of the burden of this tax falls on the buyer rather than the seller, even if it is the responsibility of the seller to collect and remit the tax. The sales tax is also a measure of ability to pay taxes, based on consumption spending.

Buyers who evade sales taxes by purchasing through catalogs or over the internet are not contributing their fair share to the cost of the public services that they enjoy. Instead, they are shifting that burden to other citizens and other taxes, such as the property tax. Because internet access is less available to low income households, the exemption of most internet sales from state and local sales taxes makes those taxes even more regressive.

The U.S. Supreme Court decision in the *Quill* case returned the issue of permitting taxation of interstate mail order and internet sales to Congress to decide. Congress has the power to permit states to require internet vendors to collect sales tax, but it has not yet acted. The Multistate Tax Commission has worked hard to make state sales tax bases more uniform in order to facilitate compliance with state and local sales taxes by catalog and internet vendors.

The State of South Carolina could take part in this effort to equalize the playing field between in-state retailers and internet vendors by urging our Congressional delegation to support legislation that would allow states to collect sales taxes on internet and catalog sales in their respective jurisdictions.