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Idea

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Modernize sales taxes for the new economy

Each Southern state should modernize its policy on taxing services and Internet sales to respond to the region's shift to the knowledge and service economy.

Background

As discussed in Idea 1, Southern states exempt or exclude certain items from sales taxes. This has created millions of dollars of holes in the tax base that have caused some to refer to sales taxes as a Swiss cheese approach to taxation. Certain exemptions are for intentional policy reasons, such as shielding poor residents from taxes on essentials goods like groceries.

But there are other tax exemptions and exclusions that have developed under the radar screen or just unintentionally. Often, they haven't even been debated by lawmakers. Instead, they arose as our economy changed, but governments didn't.

In this section, we'll review two ways that state governments can respond better to the new economy. First, they can adapt the way they tax sales to include more services, such as pet grooming, haircuts and landscaping, as Southerners continue to increase the amount of services they buy over goods. Second, lawmakers can respond more effectively to the increasing trend of people to make purchases online.

By modernizing state sales tax structures to include more services in the tax base and encouraging Internet sales taxes, states will be able to lower the sales tax rate without sacrificing revenues. In turn, the sales tax will become more representative of our 21st century spending habits.

Figure 1: Southern states on services and internet sales

State	Taxes the national average of services	Approved Streamlined Sales and Use Tax Agreement (SSUTA)
Alabama	No	No
Arkansas	Yes	Yes
Florida	Yes	No
Georgia	No	No
Kentucky	No	Yes
Louisiana	No	No
Mississippi	Yes	No
North Carolina	No	Yes
South Carolina	No	No
Tennessee	Yes	Yes
Virginia	No	No

A shrinking base

In the 1930s, Mississippi became the first Southern state to create a sales tax.[1] Other states followed suit, and every Southern state had a general retail sales tax by the late 1960s. When Southern states were designing sales taxes, primarily between 1930 and 1951, households spent a majority of their income on goods, which includes items such as clothing, appliances and furniture. However, the 21st century economy is very different from the goods-dominated economy of the 1930s.

Today's economy focuses more on services and is very different than the goods-dominated economy of the 1930s to 1950s.

Today's households spend less on goods than services, such as landscaping, tanning salons and pest control. The Center on Budget and Policy Priorities notes that goods made up 39 percent of household purchases in 1970 but dropped to 33 percent by 2001. In contrast, services continue to grow as a share of purchases, increasing from 31 percent of household purchases in 1970 to 44 percent in 2001.[2] As services continue to outpace goods in household purchases, the sales tax will suffer since sales tax bases continue to focus primarily on goods. Bottom line: the current sales tax base will continue to decline unless lawmakers reform the way sales are taxed.

In addition to more purchases of services, Americans are buying more items through the Internet. Recent estimates by Forrester Research show national online business-to-consumer sales totaled $104 billion in 2003, up 39 percent over 2002.[3] Moreover, such sales are expected to grow rapidly over the next few years. By 2008, total online sales will reach $230 billion, according to Forrester Research predictions.

As more and more purchases are made online rather than in a local store, the sales tax base will shrink since states cannot tax remote sellers (i.e., a business that does not have a physical presence in the state, such as online stores, mail order businesses and home shopping companies). And as the tax base shrinks, states lose potential revenues. This inability of states to require remote sellers to collect sales taxes results from a series of rulings by the U.S. Supreme Court. Unlike the taxation of services, which states can authorize, the taxation of Internet sales and other remote purchases is beyond the authority of the states. That means Congress must give states the authority to tax remote sellers for this part of the tax base to become available.

Treating services fairer

Southern states have the opportunity to broaden their *sales tax base* by making more services taxable. The Federation of Tax Administrators identified 168 services states could tax in 2004. As shown in Figure 2, Southern states tax between 18 and 74 of those possible 168 services. On average, Southern states tax 47 services, while the national average is 57. Hawaii, New Mexico, South Dakota and West Virginia each taxed more than 100 of the possible 168 services. Likewise, Delaware and Washington taxed more than 100 services, but did so through a gross receipts tax rather than a general sales tax.[4]

Figure 2: Taxation of services, 2004	
	Total number of services taxed (168 possible)
U.S. Average	57
Alabama	37
Arkansas	72
Florida	62
Georgia	36
Kentucky	29
Louisiana	55
Mississippi	74
North Carolina	30
South Carolina	34
Tennessee	67
Virginia	18
Source: Federation of Tax Administrators[5]	
Note: U.S. average does not include Alaska or Oregon, neither of which has a general retail sales tax.	

Southern states should review the 168 services available for taxation and consider increasing the taxation of services to at least the national average (57). While economists warn against the taxation of business-to-business services since the final product will also be taxed, most Southern states continue to have many options for taxing services that are not in that category. This progressive reform of taxing services can achieve several tax policy goals:

Fairness. Taxing more services can enhance the *fairness* of the tax between taxpayers of similar income. Economists call this an improvement in "*horizontal equity*." Taxing more services means that two similarly situated taxpayers would be taxed similarly whether they purchased goods or services. Take an example of lawn care. Currently, many states tax the purchase of a lawnmower, but do not tax the purchase of services from a landscaping business. The sales tax provides a preference for the landscaping service even though the activity is the same—a well-manicured lawn. Broadening the sales tax base to include more services will remove this unfair treatment to those who purchase goods over services.

Broadening the sales tax base to include more services will remove the unfair treatment to those who currently purchase more goods than services.

Taxing more services also can improve something called "*vertical equity*," which increases the *fairness* between low and high incomes. Wealthy households consume more services than poor households. Therefore, broadening the tax base to include a balance of goods and services makes the sales tax *fairer* across incomes—or increases *vertical equity*.[6] While including services in the tax base could slightly improve the sales tax's *vertical equity*, it will not reverse the *regressive* nature of the sales tax. Poor households will continue to pay a larger share of income in sales taxes than wealthier households.

Adequacy. Broadening the tax base to include services means more items and purchases will be taxable. Making more purchases taxable will cause an increase in sales tax collections. While the increased revenues are worth considering, it is also worthwhile for states to study how lowering the sales tax rate after the base is broadened can achieve further gains in tax *fairness*. As mentioned throughout this publication, the sales tax is today's most *regressive* tax. It takes a larger share of income from poor residents than from wealthy residents.

While taxing more services can make the tax more fair in the treatment of goods and services, it does little to reduce the current burden low-income taxpayers have when purchasing goods. Lowering the sales tax rate after broadening the base provides an even further gain in terms of tax *fairness* since all goods would be taxed at a lower rate. Legislators must weigh the need for increased funds against the need for more *progressive* taxation when deciding whether to reap the revenue gains from broadening the base or whether to lower the tax rate for a revenue-neutral approach. Other reforms, such as an earned income tax credit (Idea 4), would also help offset the *regressive* nature of the sales tax.

***Neutrality*, Stability and Administrative Ease.** *Neutrality*, stability and administrative ease can also be increased under a broader sales tax base. In terms of *neutrality*, taxing a balance of goods and services reduces the incentive for consumers to seek one economic activity over another for tax purposes. The Center on Budget and Policy Priorities also includes stability and administrative ease among the gains, since a broad base can be more stable over economic cycles and improve administration through more uniformity on purchases.[7]

Case study: South Carolina

South Carolina has many options for expanding its sales tax base by taxing more services. In 2004, South Carolina taxed only 34 out of a possible 168 services. While economists warn against taxing some business-to-business transactions since the end product will also be taxed, there are numerous household services South Carolina could tax to enhance the *fairness*, *neutrality* and stability of the tax and possibly lower the rate. For example, household services taxed in several states, but not in South Carolina, include: pet grooming, mini-storage, barber shops and beauty parlors, dating services, clothes alterations and repairs, and personal instruction, such as golf and dance lessons.[8]

Using data from the U.S. Department of Commerce Bureau of Economic Analysis, South Carolina's Board of Economic Advisors estimated that comprehensively taxing services could generate $1.3 billion in additional sales tax revenue in 2005.[9] Figure 3 provides a few examples of how much revenue certain services could generate in South Carolina according to those estimates. That estimate, however, includes many services that states are not likely to tax, such as business-to-business services like accounting and advertising services.

If South Carolina taxed more services in 2001, it could have generated an additional $669 million—which could have been used to lower the state's sales tax rate.

Michael Mazerov of the Center on Budget and Policy Priorities provides another estimate for South Carolina using only "readily-taxable" services, which are defined as services purchased primarily by households excluding education, health, legal, housing, public transit, banking, funeral, and insurance services. Mazerov estimates that taxing readily-taxable services in South Carolina would have generated $669 million in 2001.[10] Mazerov's estimate includes services that might be currently taxed in South Carolina; thus, the actual collections from taxing new services could be slightly less. While the state would need to decide which services are appropriate for taxation in South Carolina, there are numerous options for taxing more services and potentially lowering the tax rate.

Figure 3: Estimates of taxing services in South Carolina, 2005

Type of service:	Sales Tax Revenue (in millions)
Personal Services	$41.4
Auto Repair Services and Parking	$60.3
Miscellaneous Repair Services	$23.6
Amusement & Recreation Services	$39.4
Membership Organizations	$41.3

Source: South Carolina State Budget and Control Board[11]

Internet sales taxes

Another way to broaden the sales tax base is to address Internet sales and other remote sales. To date, Congress has not given states the authority to tax remote sales, which are sales made by businesses or stores that do not have a physical presence in the state. The Supreme Court has noted that sound reasons exist for state-level taxation of remote sales and Congress could authorize such taxation. Furthermore, the Court suggested Congress would be more likely to grant approval if states simplified their tax systems.[12] In an effort to simplify sales tax codes and encourage Congress to grant such authority, states have joined the Streamlined Sales Tax Project (SSTP). In 2002, participating SSTP states adopted the Streamlined Sales and Use Tax Agreement (SSUTA), model legislation that provides states "with a blueprint to create a simplified sales and use tax collection system that, when implemented, provides justification for Congress to allow states to request remote sellers to collect sales taxes."[13]

As of 2006, 19 states had enacted SSUTA. Of these states, 13 had adopted all of the SSUTA provisions, while six more states are on track to fully implement SSUTA by 2008. But only four Southern states—Arkansas, North Carolina, Tennessee and Kentucky—have approved the agreement. Kentucky and North Carolina are in full compliance, while Arkansas and Tennessee are scheduled to achieve full compliance in 2008.[14] States that join the Streamlined Sales Tax Project efforts may eventually realize several benefits from broadening the sales tax base to cover remote sales:

- ***Simplicity.*** One of the founding principles behind the Streamlined Sales Tax Project is a simplified sales tax system. *Simplicity* in the sales tax is important since retailers collect the tax and then remit it to government. When retailers are selling in multiple states that have different sales tax structures, the collection of sales taxes is more complicated and time-consuming. A simplified structure would ease the collection process and provide justification to Congress that states are prepared to tax remote sellers.

- ***Fairness.*** Excluding Internet and other remote sales from taxation lessens the *fairness* of the system for several reasons. First, online retailers have a cost advantage not enjoyed by traditional "bricks and mortar" retailers who must collect sales taxes in their stores. Similarly, out-of-state retailers can also gain an unfair advantage over in-state operators, who must collect taxes on sales. Finally, the exclusion is unfair to consumers who shop at traditional stores rather than online or through other remote sellers. Online shoppers, likely to include more wealthy households than low-income households, are able to avoid the sales tax on certain purchases.[15] This further exacerbates the *regressivity* of the sales tax.

Out-of-state online retailers have an unfair advantage over in-state retailers because some out-of-state retailers don't have to collect sales taxes currently.

- ***Adequacy.*** Nationally, e-commerce sales cost states a combined loss of between $15.5 and $16.1 billion in state and local sales tax revenues in 2003.[16] An estimate of the potential loss in state sales tax revenue in

Figure 4: Estimated state revenue losses from e-commerce in 2008

State	Low estimate (millions)	High estimate (millions)
Alabama	$179	$279.9
Arkansas	179.5	280.8
Florida	1,455.1	2,275.5
Georgia	451.4	705.9
Kentucky	258.5	404.3
Louisiana	255.6	399.7
Mississippi	231.2	361.6
North Carolina	378.3	591.7
South Carolina	243	380
Tennessee	493	771
Virginia	283.8	443.9

Source: Bruce and Fox[17]

2008 for Southern states is shown in Figure 4. In the 11 states of the American South, state governments could lose up to $6.9 billion—yes, billion—in sales tax revenues in 2008. Losses range from a high of $1.46 to $2.28 billion in Florida to a low of $179.0 to $279.9 million in Alabama.[18] These revenue losses will likely continue and increase as more consumers shop online and more businesses offer online shopping.

A more modern sales tax

Over the past several decades, the Southern economy has changed significantly. Purchasing more services than goods and buying from Internet sites instead of a local merchant are common practices today. In spite of these changes in the way we consume, states have not modernized their sales tax structures to capture the shifting consumption patterns.

Southern states need to broaden their sales tax bases by including more services, as well as encouraging Congress to grant authority for Internet sales taxation. Broadening the sales tax base should allow Southern states to lower the overall sales tax rate, a feature that would add greatly to the *fairness* of the tax system. With a broad base and a low rate, the sales tax would become more representative of our 21st century economy.

Talking points

- Southern states generally haven't modernized their sales tax structures in 50 years. Current state sales tax structures don't reflect the 21st century economy.

- States can broaden their sales tax base—and ultimately reduce sales tax rates—by taxing more services. Such a move would make the sales tax fairer and reduce hidden tax breaks that go to those who purchase more services than goods. The Center also believes reducing rates may make states more competitive.

- States also can broaden the base by taxing Internet sales. They should encourage Congress to allow them to reduce unfair competition to local merchants that results when consumers buy online from vendors who don't have to collect sales taxes.

Endnotes

[1] Conflicting reports put this date at 1930 and 1932. Also, some scholars classify earlier taxes in Alabama and Kentucky as the first sales taxes, although they were not the broad-based sales tax we generally think of today.
[2] Mazerov, Michael. "Expanding Sales Taxation of Services: Options and Issues." Center on Budget and Policy Priorities. June 2003.
[3] Carrie Johnson, "The Growth of Multichannel Retailing." Washington, DC: National Conference of State Legislatures and the National Governor's Association.
[4] Federation of Tax Administrators. "FTA Releases 2004 Survey on State Taxation of Services." *www.taxadmin.org/fta/pub/services/services04.html#summary*
[5] *Ibid.*
[6] Institute on Taxation and Economic Policy. "Should Sales Taxes Apply to Services?" Policy Brief #3, 2005.
[7] Mazerov (2003)
[8] Federation of Tax Administrators. "Services Taxed in South Carolina." 2004 Survey of Services Taxation. *www.taxadmin.org/fta/pub/services/online/service_state.taf?_function=list*
[9] Gillespie, William. Estimates on Taxing Services. South Carolina State Budget and Control Board, Board of Economic Advisors. October 2005. (Note: Gillespie notes that this estimate has a wide margin of error as the state does not have a long history of taxing services.)
[10] Mazerov (2003)

[11] Gillespie (2005)
[12] Institute on Taxation and Economic Policy. "Should States be Allowed to Tax Internet Sales?" Policy Brief #2. 2005.:
[13] National Conference of State Legislatures, "Governor Owens' Nine Misconceptions about the Streamlined Sales and Use Tax Agreement."
[14] Official web site of the Streamlined Sales Tax Governing Board. Available at *http://www.streamlinedsalestax.org/*
[15] Institute on Taxation and Economic Policy. "Should States be Allowed…" (2005)
[16] Bruce, Dr. Donald and Dr. William F. Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." University of Tennessee, Center for Business and Economic Research. July 2004. *http://cber.bus.utk.edu/ecomm/ecom0704.pdf.*
[17] *Ibid.*
[18] *Ibid.*