SALES TAXATION OF SERVICES: AN ECONOMIC PERSPECTIVE

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I. INTRODUCTION

State sales taxation of services has a long and controversial history. When the states first began utilizing the sales tax in the 1930s, the tax base was largely confined to tangible personal property. Subsequently, many states have, to varying degrees, extended their sales tax bases to include services, but such efforts typically have been far from comprehensive and have often generated considerable controversy.[1] The most celebrated example of the latter phenomenon occurred in Florida, where the state in 1987 enacted sweeping legislation that extended the state sales tax to a broad spectrum of services, only to rescind the legislation a short six months later in response to a whirlwind of criticism.[2] Despite this experience, the Florida legislature is once again considering expanding its sales tax base to include a wide variety of services purchased by both businesses and households, with the resulting revenue used to reduce the state sales tax rate from 6% to 4.5%.[3]

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1. *See* William F. Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 NAT'L TAX J. 19, 19 (1988).
2. FLA. STAT. § 212.059 (1987), *repealed by* Act effective Jan. 1, 1988, ch. 87-548, 1988 Fla. Laws 19 (Special Session D (Dec. 1987)).
3. *See* Fla. SJR 938 (2002) (proposed FLA. CONST. art. VII, § 19).

In some respects, the Florida case—which is the focus of this Forum—is unique. The state's recent rapid growth, coupled with its constitutional prohibition of state personal income tax,[4] suggests that its sales tax revenue needs may be greater than those of the typical state. As a result, pressure for expanding the sales tax base to include services may be unusually great in Florida. However, the general economic issues raised in the ongoing debate in Florida are common to all of the forty-five states (plus the District of Columbia) that utilize the sales tax.

It is these issues that are the focus of this Article. The analysis begins in Part II with a brief overview of current practice in the sales taxation of services in the United States, as well as a brief outline of the Florida proposal. It turns next in Part III to the question of whether services should, in principle, be included in the base of the sales tax, and then in Part IV discusses the characteristics of the sales taxes currently used by the states. In Part V, the Article addresses several potential approaches to reform of the existing system, all of which include expansion of the base to include some services. The Article concludes in Part VI with a summary evaluation of these options.[5]

II. CURRENT PRACTICE AND THE FLORIDA PROPOSAL

The current practice in the sales taxation of services is described by Due and Mikesell as "very mixed, ranging from virtually no taxation (except transient accommodations) to very broad coverage."[6] For example, California and Nevada tax very few services, while Hawaii, New Mexico, and South Dakota apply the tax to a broad range of services.[7] The other states that utilize the sales tax fall somewhere in between these two extremes. Hotel and motel services are universally taxed (although sometimes with special taxes at rates that can differ from the general sales tax rate), reflecting the popularity of using taxes that are perceived to be born by nonresidents of the taxing states.[8]

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4. FLA. CONST. art. VII, § 5(a).

5. This Article draws on several recent excellent studies of the sales taxation of services. *See* JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION (Urban Inst. Press 2d ed. 1994) (1983); *see also* Fox & Murray, *supra* note 1; Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1 (1988); Perry D. Quick & Michael J. McKee, *Sales Tax on Services: Revenue or Reform?*, 41 NAT'L TAX J. 395 (1988).

6. DUE & MIKESELL, *supra* note 5, at 90. The following discussion draws on *Sales Taxation: State and Local Structure and Administration*, which should be consulted for further details. *See id.*

7. *See id.* at 89; Hellerstein, *supra* note 5, at 15 n.4.

8. *See* DUE & MIKESELL, *supra* note 5, at 93.

Public utilities offer a good example of the variation in the tax treatment of services across states. Many states tax most utility services, including those provided to businesses, and all states tax at least some. Some states apply sales tax to residential electric power, while others utilize a special utility tax (which again may or may not have the same rate as the sales tax).[9] A few states (Minnesota and Wisconsin, for example) exempt electricity for heat during winter months, while others exempt a certain number of kilowatt-hours for low-income households.[10] Roughly three-quarters of the states tax local telephone services, with about half extending the sales tax to long-distance services.[11] Cable television is taxed in roughly half of the states.[12]

Sales taxation of other services varies to an even greater degree. Almost all states tax rentals of tangible personal property to some extent, again reflecting the popularity of taxes that may be exported to nonresidents, and most states tax admissions to amusements.[13] However, repairs of tangible personal property are taxable in only about half of the states, and only roughly a quarter of states tax repairs of real property.[14] About half of the states tax custom-programmed computer programs (although virtually all tax packaged software).[15] Relatively few states tax professional services, especially medical services, which are exempt largely on grounds that they are a "merit good" that should remain untaxed.[16] Services rendered in conjunction with the sale of tangible personal property (e.g., warranties, financing, and transportation) are generally nontaxable if quoted separately on the billing invoice.[17]

Current practice in the sales taxation of services thus varies considerably across the states. If the current proposal for state taxation of services in Florida were enacted, the state would be among the states with the most comprehensive coverage of services. The current proposal—like the law enacted in 1987—would extend the sales tax to a broad range of services.[18] Services that would be taxed include advertising, legal services, accounting services, transportation and construction services, automobile repair, recreational services, personal grooming services, and investment counseling. In contrast to

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9. *See id.*
10. *Id.*
11. *Id.* at 83-84.
12. *Id.* at 93.
13. DUE & MIKESELL, *supra* note 5, at 94-95.
14. *See id.* at 94.
15. *Id.* at 95.
16. *See id.*
17. *Id.* at 95-96.
18. See Hellerstein, *supra* note 5 (presenting a detailed description of the 1987 law in Florida and discussing the factors that led to its downfall).

the situation in most states under which services are subject to taxation only if they are specifically enumerated as taxable, the Florida proposal takes the more comprehensive approach of specifying that services are taxable unless specifically exempted.[19] Exempt services include medical and health services, educational and social services, communication services, and services that employees provide for their employers.[20]

The most recent proposal also outlines several additional types of services that could be exempted by the legislature, including support services for educational, governmental, religious, or charitable institutions, services that promote economic development and competitiveness, and services whose exemption would promote equity by reducing the regressivity of the sales tax.[21] The current proposal also maintains the feature of the 1987 law that gave rise to the most criticism and ultimately led to the demise of the law: taxation under the state use tax of services,[22] including national advertising, performed in other states but used in Florida (as long as the service was not already subject to tax in the state in which it was performed).[23]

III. SHOULD SERVICES BE TAXED UNDER AN "IDEAL" SALES TAX?

Given the wide variation in the extent to which the states tax services, a natural question is whether a sales tax that is "ideal" from an economic perspective would include services in the tax base. In terms of first principles, the answer to this question is straightforward and befitting any good two-handed economist—yes and no. However, despite the ambiguity suggested by this response, there is in fact a great deal of consensus among public finance specialists on the appropriate treatment of services under an ideal sales tax—all services sold to consumers should be fully taxed, while all services sold to businesses should be excluded from the sales tax base. Furthermore, there is general agreement that the tax should be assessed on a "destination" basis—that is, as a consumption-based rather than a production-based tax, sales tax revenue should be collected by the jurisdiction of residence of the consumer.[24]

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19. *See* Fla. SJR 938 (2002) (proposed FLA. CONST. art. VII, § 19(2)).

20. *See id.*

21. *See id.*

22. The Florida experience was not unique, as proposals to broaden the sales tax base to include a broad range of services have also failed in Nebraska, Ohio, Oklahoma, Illinois, and Indiana.

23. *See* Hellerstein, *supra* note 5, at 6-7.

24. For example, this consensus is reflected in the 1983 and 1994 works of Due and Mikesell. DUE & MIKESELL, *supra* note 5; *see also* JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 321 (1983). This consensus is also reflected in Quick & McKee, *supra* note 5, at 399. *See also* GEORGE R. ZODROW, STATE SALES AND INCOME TAXES 130-31 (1999); Charles E. McLure, Jr., *Rethink-*

A number of rationales underlie this position. At one level, the argument is tautological. A "retail" sales tax is by definition a tax on final sales to consumers—that is, a tax that is designed to be based on consumption. As such, it should tax all consumer products, including consumer services, while exempting all business inputs, including producer services.

More substantively, several compelling economic arguments support this position. For example, many—although by no means all—economists argue that taxation on the basis of consumption is inherently preferable to taxation on the basis of income.[25] In particular, in contrast to income-based taxes, consumption taxes do not discourage individual saving and do not create tax disincentives to investment.[26] Some studies suggest that the economic gains from using consumption-based rather than income-based taxation at the national level are relatively large.[27] However, any potential gains from nationwide use of a consumption-based tax system at the state level can be achieved only if the states are in fact administering a tax that has consumption as its base—a result obtainable only with comprehensive taxation of all consumer expenditures, including consumer services, and exemption of all business purchases, including services provided to businesses.[28] Similarly, if a state is concerned about using tax policy to encourage economic development, it should avoid the taxation of business inputs, which creates a tax disincentive to investment in the state.[29]

This prescription for an ideal sales tax is arguably supported by the optimal taxation literature. In particular, one of the basic tenets of this literature is the "production efficiency" theorem, which concludes that under the appropriate circumstances, taxes on production

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ing State and Local Reliance on the Retail Sales Tax: Should We Fix the State Sales Tax or Discard It?, 2000 BYU L. REV. 77, 83-84.

25. For reviews of these arguments, see DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 312-34 (1986), and George R. Zodrow & Charles E. McLure, Jr., *Implementing Direct Consumption Taxes in Developing Countries*, 46 TAX L. REV. 405, 407-08, 428-57 (1991).

26. These arguments are of course stressed by proponents of recent proposals for "fundamental" national tax reform in the form of replacing the income tax with a consumption-based tax. For a collection of recent articles that address various aspects of the income vs. consumption tax debate, see UNITED STATES TAX REFORM IN THE 21ST CENTURY (George R. Zodrow & Peter Mieszkowski eds., 2002).

27. *See, e.g.*, David Altig et al., *Stimulating Fundamental Tax Reform in the United States*, 91 AM. ECON. REV. 574, 593 (2001); *see also* Dale W. Jorgenson & Peter J. Wilcoxen, *The Economic Impact of Fundamental Tax Reform*, *in* UNITED STATES TAX REFORM IN THE 21ST CENTURY, *supra* note 26, at 55, 87-88. For a critical review of such results, see Jane G. Gravelle, *Behavioral Responses to a Consumption Tax*, *in* UNITED STATES TAX REFORM IN THE 21ST CENTURY, *supra* note 26, at 25, 53-54.

28. *See* ZODROW, *supra* note 24, at 130.

29. For further discussion, see George R. Zodrow, *Streamlining the Sales Tax: Implications for Economic Growth*, 26 ST. TAX NOTES 251, 257 (2002).

inputs should be avoided entirely.[30] The basic intuition behind this result is that the appropriate set of taxes on consumption goods alone can achieve any outcome that would obtain under taxation of production inputs, but consumption taxes avoid the distortions of input choices that arise with production taxes.[31] Although this result is subject to several important qualifications,[32] it suggests the presumption that business inputs, including services consumed by businesses, should be exempt from state sales taxes, which should be confined only to consumption expenditures.

Several additional related arguments buttress this position. Most importantly, taxing business inputs is undesirable because it results in highly inefficient tax pyramiding, as multiple layers of taxation are applied to those products whose inputs happen to be subject to sales taxation.[33] Tax pyramiding thus results in either (or both) haphazard consumer price differentials that distort consumer choices, and similarly haphazard factor price differentials that distort input choices as well as business location decisions across states.[34] Tax pyramiding also provides incentives for inefficient vertical integration, as firms attempt to avoid sales taxation of business inputs by producing the taxed inputs in-house.[35] Furthermore, such tax incentives for vertical integration imply a tax bias favoring large established firms over newer and smaller enterprises, since it is generally easier for larger firms to achieve vertical integration.[36] Finally, taxing business inputs is also likely to hamper exports to other states, as it raises the cost of producing those goods and services, relative to the costs experienced by firms in states that do not tax business inputs or tax them at lower effective rates.

Moreover, optimal taxation theory also suggests that uniform taxation of all consumption commodities is optimal under certain conditions, especially if the government also has a non-linear income

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30. *See* Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, 4 J. ECON. PERSP. 157, 162-63 (1990).

31. *Id.*

32. In particular, the production efficiency theorem requires that all commodity taxes be set optimally and that all above-normal profits be taxed. If these conditions are not obtained, then taxation of production inputs may be desirable in an attempt to offset the problems associated with suboptimal (or non-existent) commodity taxes and/or untaxed economic profits. However, it would be difficult for the taxation of business inputs under the sales tax to be used effectively to achieve these goals, which could be better achieved with specific excise taxes or special sectoral taxes, if deemed desirable and feasible. *See id.*; *see also* Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production: I—Production Efficiency*, 61 AM. ECON. REV. 8, 24-26 (1971); Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production: II—Tax Rules*, 61 AM. ECON. REV. 261, 277 (1971).

33. *See* Fox & Murray, *supra* note 1, at 29.

34. *Id.* at 24-29.

35. *Id.* at 28-29.

36. *Id.* at 28.

tax at its disposal to help meet its distributional goals.[37] This result accords with the intuition that commodity tax differentials, which distort consumer decisions among various consumer products (such as the choice between goods and services),[38] should be avoided by imposing a tax system that is neutral across consumer choices, such as a sales tax that uniformly taxes all consumer products, but exempts all business inputs. Similarly, such an approach is consistent with the standard prescription for taxing on a base that is as broad as possible, in order to reduce the efficiency costs of tax-induced economic distortions. (In the case of taxing consumption, these are primarily distortions of the labor-leisure choice and distortions of consumer choices across consumption products.)

However, optimal commodity taxation theory more generally concludes that commodity tax differentials are desirable. Although in practice, the pattern of optimal differentials is difficult to determine. For example, on efficiency grounds the optimal tax rates on goods that face relatively inelastic demands tend to be relatively high.[39] However, to the extent such goods are consumed disproportionately by the poor, equity concerns imply that these tax rates should be relatively low.[40] Striking the correct balance between these two offsetting tendencies is difficult, especially since the information required to determine an optimal commodity tax structure is often not readily available. Thus, a neutral commodity tax structure—that is, a sales tax that applies uniformly to all consumption commodities—is likely to be a reasonable approximation to an optimal commodity tax system.

Practical considerations strongly reinforce this judgment, as differential tax rates are difficult to administer, especially since they inevitably raise extremely troublesome classification issues and create incentives for tax avoidance and evasion.[41] Moreover, "real world" commodity tax differentials are more likely to reflect political factors

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37. *See* A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct versus Indirect Taxation*, 6 J. PUB. ECON. 55, 67-70 (1976). More recently, Emmanuel Saez confirms in a more general framework the basic results that production taxes (or subsidies) and differentiated commodity taxes are suboptimal if redistributive goals can be attained with a non-linear income tax. *See* EMMANUEL SAEZ, DIRECT OR INDIRECT TAX INSTRUMENTS FOR REDISTRIBUTION: SHORT-RUN VERSUS LONG-RUN 2 (Nat'l Bureau of Econ. Research, Working Paper 8833, 2002); *see also* EMMANUEL SAEZ, THE DESIRABILITY OF COMMODITY TAXATION UNDER NON-LINEAR INCOME TAXATION AND HETEROGENEOUS TASTES 2 (Nat'l Bureau of Econ. Research, Working Paper No. 8029, 2000).

38. For example, Merriman and Skidmore provide empirical evidence which suggests that the tax bias which arises because services are largely exempt under state sales taxes has contributed to the differentially high growth rate of services in the United States. David Merriman & Mark Skidmore, *Did Distortionary Sales Taxation Contribute to the Growth of the Service Sector?*, 53 NAT'L TAX J. 125, 126 (2000).

39. Slemrod, *supra* note 30, at 159.

40. *See id.* at 160.

41. *See id.* at 168-73.

than optimal tax considerations, and thus reduce, rather than enhance, economic efficiency.[42] As noted above, one of the largest deviations from economic neutrality under the existing sales tax system is the exemption from taxation of many consumer services. Thus, broadening the sales tax base to include consumer services is clearly consistent with increasing the neutrality of the sales tax system.

In addition, increasing the comprehensiveness of the sales tax base by including consumer services has several other advantages. For example, adding consumer services to the sales tax base should increase the revenue stability of the tax system. Revenue stability has two components—stability over the business cycle and stability over time in the presence of economic growth. First consider revenue stability over the business cycle, where the critical issue is the relative stability of various components of income in the presence of income fluctuations. The central implication of the standard life-cycle model of individual behavior is that consumption is more stable than income over the business cycle. This in turn implies that a broad consumption tax base, which would include consumer services, is likely to enhance revenue stability over the business cycle. Richard Dye and Therese McGuire confirm this notion, as their estimates indicate that the revenue variability of a narrowly based sales tax (which excludes food for home consumption, personal and repair services, recreational services, and motor vehicle fuels) is nearly twice that of a more broad-based sales tax.[43] Moreover, taxing consumer services, which are difficult to stockpile and thus vary relatively little over the business cycle, may increase revenue stability more than taxing other consumer products.[44]

The second element of revenue stability is stability in the presence of economic growth. The basic argument for taxing consumer services is that since they have been growing as a percentage of personal consumption expenditures, excluding consumer services from the state sales tax base implies a uniformly declining tax base relative to total personal consumption. If government expenditures relative to personal consumption are constant or increasing over time, persistent revenue shortfalls and fiscal crises are the inevitable result.[45]

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42. For further discussions of the practical difficulties of implementing commodity tax differentials and the administrative case for uniform taxation, see Arnold C. Harberger, *The Uniform-Tax Controversy*, *in* PUBLIC FINANCE, TRADE AND DEVELOPMENT 3 (Vito Tanzi ed., 1990). *See also* Slemrod, *supra* note 30.

43. Richard F. Dye & Therese J. McGuire, *Growth and Variability of State Individual Income and General Sales Taxes*, 44 NAT'L TAX J. 55, 58-60 (1991).

44. *See* Quick & McKee, *supra* note 5, at 402.

45. *See* Steven D. Gold, *Florida's Sales Tax on Services: Aberration or Innovation?*, ST. LEGISLATURES, Jan. 1988, at 10-11.

The data presented in Table 1 suggest that this is in fact the case, as consumer services as a percentage of total personal consumption have increased steadily and dramatically from 41.0% in 1960 to 58.5% in 2000.[46] Thus, adding consumer services to the tax base should increase the revenue stability of the sales tax base in the presence of economic growth. Note, however, that the importance of this phenomenon appears to have declined in recent years, as personal services as a fraction of total personal consumption grew by only one-half of one percentage point from 1995 to 2000.[47] If this trend continues, the gain in revenue stability in the presence of economic growth from taxing consumer services will diminish as well.

Table 1. Consumer Services (CS) as a Fraction of Personal Consumption (PC)[48]

Year	1960	1965	1970	1975	1980	1985	1990	1995	2000
CS/ PC	.41	.427	.45	.462	.484	.524	.553	.579	.585

Broadening the sales tax base to include all consumer goods, including consumer services, is desirable on equity grounds as well. The failure to tax certain consumer products, such as consumer services, discriminates against individuals who have a relatively high preference for taxed consumer products, while favoring those with a relatively high preference for untaxed consumer products. Moreover, broadening the tax base to include all consumer products may reduce the regressivity of the sales tax if the newly taxable products are consumed disproportionately by relatively wealthy households. This may be the case for services, as higher income groups may consume proportionately more potentially taxable services than taxable goods.[49]

However, the empirical evidence on this issue suggests that such effects may be small, and will vary considerably depending on the details of the reform proposal and the existing sales structure. For example, John J. Siegfried and Paul A. Smith estimate that the tax system introduced in Florida in 1987 (including taxation of both con-

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46. *See infra* tbl.1.
47. *Id.*
48. The figures in Table 1 are obtained from the Bureau of Economic Analysis, *National Product and Income Accounts*, tbl. 2.2, *available at* http://www.bea.gov/bea/ch/nipaweb/dn/nipaweb/TableViewFixed.asp#Mid (last visited Nov. 18, 2002) (on file with author).
49. Fox & Murray, *supra* note 1, at 29-31; *see also* Quick & McKee, *supra* note 5, at 401.

sumer and business services) was less regressive than the subsequent sales tax increase on commodities,[50] but note that the differential effects on the income distribution within the state of the two alternative sales tax systems was quite small.[51]

Taxes on final consumption goods are also much more visible to the public than taxes on businesses. Such transparency—while perhaps unattractive to government officials and political leaders—is desirable from a public choice perspective to limit any tendencies toward excessive expenditures on public goods. Finally, taxing all consumption products, including consumer services, tends to simplify the tax system by eliminating distinctions between taxable and non-taxable products that are often arbitrary and in practice difficult to draw. Taken together, these arguments provide strong support for the conventional prescription that an ideal sales tax would uniformly tax all consumer products, including consumer services, and exempt all business inputs, including business purchases of services.

IV. THE CURRENT SALES TAX SYSTEM

The sales taxes currently used by the states differ significantly from the ideal tax described above and, as will be discussed below, these deviations complicate the evaluation of any proposal for expanded sales taxation of services. There are several problem areas. Most obviously, the bases of current sales taxes do not capture all consumption. Some of the exemptions reflect distributional concerns (for example, food for home consumption), while others reflect the perception that certain "merit" goods (for example, prescription drugs, medical and health care services, and education) should be tax-exempt.[52]

More relevant to the case at hand, however, is the fact that consumer services are often exempt from taxation, partially for historical reasons (as noted above, sales taxes initially applied almost exclusively to tangible personal property) and partly because many customer services are difficult to tax from an administrative standpoint (for example, housekeepers and gardeners). In addition, consumption of housing services is taxed only indirectly (through the taxation of

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50. John J. Siegfried & Paul A. Smith, *The Distributional Effects of a Sales Tax on Services*, 44 NAT'L TAX J. 41, 52 (1991).

51. *Id.* For further discussion, see Fox & Murray, *supra* note 1, at 29-31 (including a description of Robert A. Bohm & Eleanor D. Craig, *Sales Tax Base Modification, Revenue Stability, and Equity*, *in* NATIONAL TAX ASSOCIATION—TAX INSTITUTE OF AMERICA PROCEEDINGS OF THE ANNUAL CONFERENCE 1987, at 167 (1987).

52. Note that these merit good arguments are compelling only for essential expenditures, such as for basic medical care, rather than for non-essential expenditures, such as elective cosmetic surgery. William F. Fox, *Sales Taxation of Services: Has Its Time Come?*, *in* SALES TAXATION: CRITICAL ISSUES IN POLICY AND ADMINISTRATION 51, 54 (William F. Fox ed., 1992).

some of the inputs into its production) and most sales of intangible consumer goods are not subject to tax. As a result, the typical sales tax falls far short of taxing all consumption. For example, Cline and Neubig estimate that in 1998, only thirty-four percent of consumption expenditure was subject to sales and use taxes, a figure that has declined from thirty-nine percent in 1985.[53]

Moreover, even if an item of personal consumption is generally subject to sales taxation in a given state, it is often effectively exempt from tax if purchased from a remote vendor, that is, a vendor located outside the taxing jurisdiction. Under current law, remote vendors cannot be required to collect sales tax, but can be required to collect a complementary "use" tax—on the use of the good or service in the taxing state—if the vendor has a sufficient physical presence or "nexus" in the taxing state.[54] However, in the absence of nexus, the United States Supreme Court has ruled that remote vendors cannot be required to collect use tax on grounds that the current system of state sales taxes is far too complex to reasonably impose such a requirement.[55] As a result, a significant fraction of remote sales—including mail order sales and, more recently and potentially much more importantly, electronic commerce—is effectively not subject to the sales tax.[56]

Thus, the treatment of remote sales introduces another component of consumption that largely escapes taxation.[57] In addition to narrowing the consumption tax base, such treatment is inefficient and inequitable in that it provides a tax bias favoring remote over local vendors. At the present time, this problem is relatively small. For example, mail order consumer sales comprised 1.3% of total consumption in 2000 ($88.5 billion) while consumer sales over the Internet were 0.3% of total consumption ($21.4 billion), up from 0.18% in

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53. Robert J. Cline & Thomas S. Neubig, *The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, 17 ST. TAX NOTES 43, 45-46 (1999). William F. Fox also discusses the narrowness of the typical sales tax base. *See* William F. Fox, *Can the State Sales Tax Survive a Future Like Its Past?*, *in* THE FUTURE OF STATE TAXATION 33, 42-44 (David Brunori ed., 1998).

54. *See* Fox, *supra* note 53, at 40-42.

55. The two most important cases are *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), *rev'd*, 504 U.S. 298 (1992).

56. For further discussion of the problems of subjecting remote commerce, including electronic commerce, to the sales tax, see Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 302-03 (1997). *See also* John L. Mikesell, *The Future of American Sales and Use Taxation*, *in* THE FUTURE OF STATE TAXATION, *supra* note 53, at 29.

57. Individuals and firms who purchase taxable goods from remote vendors are in principle required to pay use tax to their home state. Although businesses typically comply with such rules, individuals typically ignore them (if in fact they are even aware of them) except in the case of items, such as automobiles and boats, that must be registered in the taxing state.

1999 ($11.7 billion).[58] However, the recent rapid growth of Internet sales (for example, the sixty-seven percent increase from 1999 to 2000 indicated above) suggests that the importance of this omission from the sales tax base may become considerably greater over time.[59]

Finally, in addition to missing a large fraction of total consumption, the base of the typical state sales tax includes a significant amount of business inputs. Most states recognize that business inputs should in principle be exempt from sales taxation. Accordingly, businesses are typically provided with exemption certificates that allow them to purchase items that have been designated as tax exempt when purchased by a business. Such items include goods sold for subsequent resale, property that becomes a component of a manufactured product, property that will be consumed in manufacturing or processing and, in some cases, machinery and equipment used in manufacturing. However, partly out of concern that businesses will use their exemption certificates to make personal consumption purchases on a tax-free basis, and partly as a policy decision to expand the sales tax base and lower rates by including some business purchases, most states place significant limits on the use of exemption certificates.

As a result, the typical state sales tax base includes a sizable amount of business purchases. Indeed, one often-cited study estimates that business purchases make up, on average, forty percent of state sales tax bases.[60] This implies that in practice the state sales tax is more of a haphazard income tax than a true consumption tax (since it taxes so many business inputs and so much business investment), and that all of the problems of tax pyramiding detailed above plague the current system to a significant degree. As will become clear below, the fact that the current sales tax system diverges so dramatically from an ideal system greatly complicates the evaluation of proposals to add services to the sales tax base.

V. REFORMING STATE SALES TAXATION OF SERVICES

Increased sales taxation of services might occur under three alternative scenarios. The first would be to increase taxation of con-

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58. These figures are based on data from the U.S. CENSUS BUREAU, 2000 ANNUAL RETAIL TRADE SURVEY tbl.5 & tbl.6 (2000), *available at* http://www.census.gov/svsd/retlann/view/artse-comm.pdf (last visited Nov. 18, 2002) (on file with author).

59. For estimates of future levels of electronic commerce, see Donald Bruce & William F. Fox, *E-Commerce in the Context of Declining State Sales Tax Bases*, 53 NAT'L TAX J. 1373, 1382 (2000); *see also* Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, 52 NAT'L TAX J. 413, 417 tbl.2B (1999).

60. Raymond J. Ring, Jr., *Consumers' Share and Producers' Share of the General Sales Tax*, 52 NAT'L TAX J. 79, 81 tbl.1 (1999). The estimates provided by Ring range from eleven to seventy-two percent; in Florida, Ring estimates that business purchases comprise fifty percent of the sales tax base. *Id.*

sumer services (and eliminate taxation of business services) as part of a comprehensive reform of a state sales tax structure, moving it toward the "ideal" tax on consumption described above. The second would be an expansion of the sales tax base to include those consumer services not yet subject to tax. Finally, as in the case of the current Florida proposal, the reform could involve an expansion of the sales tax base to include both business and consumer services, coupled with a reduction in the general sales tax rate. This Section considers each of these reform approaches in turn. Although the discussion thus far has focused on reform within a single state, sales tax reform could of course also reflect a coordinated reform effort by all the states that utilize the tax. Since such efforts have generated considerable interest recently, the coordinated approach is discussed briefly below in the case of comprehensive state sales tax reform.

A. Taxing Services as Part of a Fundamental State Sales Tax Reform

As suggested by the discussion thus far, increased taxation of consumer services, coupled with exemption of business services, would be an essential element of a movement toward the ideal sales tax, a comprehensive tax on all consumption expenditures—long recommended by public finance experts. Such an approach has been advocated recently in the context of a coordinated sales tax reform by McLure who, partly in response to concerns raised by potential tax base erosion due to the growth of electronic commerce, has argued for a completely revamped "ideal retail sales tax" system.[61] Under this approach, all states would agree on a common sales tax base that ideally would include all consumption items, including services consumed by individuals—or would have at most a few common exempt items—and would exclude all business purchases, including services provided to businesses.[62] Given the common comprehensive consumption base, states would be free to set their own rates.

Such a comprehensive reform would achieve all of the gains in simplicity, economic neutrality and equity detailed above. In addition, under McLure's proposal, all states would agree on common simplified administrative procedures (registration, filing, tax payment, audit, appeals, etc.) and a uniform legal framework (statutes, regulations, and interpretations).[63] The resulting national sales tax system would quite possibly be sufficiently simple to prompt either congressional or judicial action to impose a requirement that remote

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61. Charles E. McLure, Jr., *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 URB. LAW. 487, 491-95 (2002).
62. *Id.* at 494.
63. *Id.*

vendors collect use tax, thus ensuring that all consumption would be taxed on a destination basis.[64]

Such an approach would require a mechanism that would ensure that all business purchases are exempt from sales tax, while protecting against evasion in the form of business purchases of personal consumption items for the owners or employees of the business. McLure recommends that all businesses be issued a uniform exemption certificate that would allow them to make business purchases on a tax-exempt basis.[65] Business purchases would be defined as those that are deductible under the federal income tax.

An alternative method of treating business purchases is outlined by Gillis, Mieszkowski, and Zodrow.[66] This approach would impose sales tax on all business purchases of "dual use" goods—goods that can be business inputs but can also be items of personal consumption. Businesses would then be required to file for a refund of sales tax assessed on the purchases of business inputs, perhaps on a monthly or quarterly basis.[67] Such an approach would clearly be cumbersome from an administrative standpoint, as it would involve collecting a significant amount of tax only to refund it.[68] However, it might be more effective than the exemption certificate approach in preventing evasion in the form of business purchases of personal consumption items.

Specifically, under the refund approach, businesses would have to fraudulently petition the tax authorities for a refund on purchases of personal consumption items. By comparison, under the exemption certificate approach, businesses need only misrepresent their intentions to the vendor, who is indifferent to their fraudulent intent (and

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64. In 1992, the United States Supreme Court held that economic presence—rather than only physical presence—was adequate to justify the imposition of a requirement on remote vendors to collect use taxes. Quill v. North Dakota, 504 U.S. 298, 308 (1992). Thus, the *Quill* decision left open the possibility of (1) congressional action granting states the power to require use tax collection by remote vendors; or (2) a judicial reversal of *Quill* if the state and local sales tax system were simplified to a sufficient extent. *Id.* at 318. The McLure approach is clearly more comprehensive than the reforms currently being discussed by the Streamlined Sales Tax Project (SSTP), an ongoing effort at simplification of the state sales and use tax system that involves forty-one of the forty-six states (counting the District of Columbia) that levy the sales tax, including thirty-six voting participants and five observer states. The SSTP approach would create a common menu of items that could then be classified as either taxable or tax-exempt in each state, using technology-based collection methods to determine state and local tax liability for remote vendors. For discussions of the STTP approach, see Arthur R. Rosen & Susan K. Haffield, *The Streamlined Sales Tax Likely to Affect All American Businesses*, 22 ST. TAX NOTES 1087 (2001); *see also* McLure, *supra* note 61, at 500-20; Zodrow, *supra* note 29.

65. McLure, *supra* note 61, at 494.

66. Malcolm Gillis et al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 731-32 (1996).

67. *Id.*

68. In this respect, the refund approach is similar to zero-rating under a value-added tax (VAT).

indeed may wish to be perceived as receptive to such fraud in order to stimulate sales). As stressed by Mikesell, businesses may be much more reluctant to misrepresent their purchases to the government than to an anonymous vendor at the point of sale.[69]

In any case, under either approach it is clear that great care would have to be taken to ensure that the exemption of business purchases under the sales tax was not abused, especially by the owners of closely held businesses. In addition, certain deductions that are allowed, or partially allowed, under the federal income tax might be fully taxable under the sales tax. The most obvious example is expenses for meals and entertainment, which are currently partially deductible under the income tax, but should (arguably) be fully taxable under the sales tax, especially given the considerable potential for evasion in this area. Another area of potential abuse that would have to be closely monitored lies in the purchase of professional services. For example, the owners of a business could arrange for the tax-free purchase of legal or accounting services at an inflated price, in exchange for a reduced or zero price on taxable personal legal and accounting services for themselves, family members, or employees.

A separate issue is the taxation of necessities, which are typically exempt from the sales tax on distributional grounds and merit goods, such as medicines, medical and health care services, and educational services. Although such exemptions are certainly popular, they are an exceedingly poor way of achieving equity goals, since the benefit of exemption accrues not only to the poor but also to those in higher income classes. Indeed, the benefit of exemption increases with income, although less than proportionately if the exempt commodities are chosen appropriately. As a result, relatively small redistributional gains are obtained at a high revenue cost, implying that rates under the sales tax must be relatively high. In addition, exemptions add complexity to the sales tax system, especially since they typically involve difficult classification issues, and thus result in rather high administrative and compliance costs and create opportunities for tax avoidance and evasion. In general, expenditure programs and a moderately progressive income tax at the state level are far better ways to achieve distributional goals.[70]

If additional relief is desired for the very poor to ensure that they pay little or no sales tax, consideration should be given to a means-tested tax rebate program. Under such a program the poor would re-

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69. John L. Mikesell, *Is the Retail Sales Tax Really Inferior to the Value-Added Tax?*, *in* THE SALES TAX IN THE 21ST CENTURY 75, 80 (Matthew N. Murray & William F. Fox eds., 1997).

70. Given the mobility of high income individuals across states, a steeply progressive income tax is inadvisable at the state level. For a discussion of this point, see ZODROW, *supra* note 24, at 9-10.

ceive a rebate that would approximate sales tax paid, which could be administered as part of the state income tax (in those states with a personal income tax) or as an independent program.[71] Such an approach involves considerable administrative costs, as it requires a means for identifying which taxpayers qualify for the rebate, and a method for delivering the rebates. In addition, it imposes additional complexity for the poor, who must file for the rebates, and it introduces the potential for fraud. Nevertheless, it is a more efficient and equitable way of achieving distributional goals than the use of exemptions under the sales tax.[72]

The net revenue impact of enacting such a reform package would of course vary from state to state. Broadening the tax base to include consumer services as well as currently exempt consumption goods (net of any rebate program) would raise revenues, as would any increased taxation of remote vendors. On the other hand, eliminating sales taxation of business inputs would reduce revenues significantly. Within the context of fundamental reform of a state sales tax, any revenue gain or shortfall should be eliminated with the appropriate adjustment of the state sales tax rate. If it is determined that revenues need to increase, this should be accomplished with a rate increase applied to the new comprehensive consumption tax base, without resorting to a return to the taxation of business inputs.

B. Taxing Consumer Services

A much more modest reform would be to expand the coverage of consumer services under the sales tax, as has been done to varying extents in many states. Such a reform is also generally desirable, although the gains in economic neutrality, equity, and simplicity would be far smaller than under the comprehensive reform proposal discussed in the previous Section, and the revenues gained would be relatively modest.

In particular, as discussed at length above, bringing consumer services into the sales tax base would (1) reduce distortions of consumer choices;[73] (2) lower the overall tax rate and thus reduce the

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71. An alternative is a universal (non-means-tested) rebate. Although simpler to administer, the universal rebate is more costly than the much more highly targeted means-tested rebate, and has the perception problems associated with cash rebates to the very wealthy. For further discussion, see Edith Brashares et al., *Distributional Aspects of a Federal Value-Added Tax*, 41 NAT'L TAX J. 155 (1988).

72. For further discussion, see Gillis et al., *supra* note 66, at 764-68.

73. Although from a theoretical perspective it is not unambiguously true that increasing tax rates on previously untaxed goods will increase efficiency, there is a presumption that this is the case. In particular, Tatsuo Hatta shows that moving from a differentiated tax system to a uniform tax results in efficiency gains as long as the tax rate being increased applies to a good that is substitutable with all other goods and results in a revenue

cost of the remaining distortions in the system; (3) reduce the inequities that arise when certain consumer goods are tax favored; (4) simplify the system by eliminating the need to distinguish between similar consumer goods and services; (5) increase the visibility of the tax system and thus promote better decisions regarding the size of the public sector; (6) help stabilize sales tax revenues (to a lesser extent); and (7) increase the vertical equity of the sales tax system. For all of these reasons, expanding the sales tax base to include consumer services is generally desirable.[74]

Nevertheless, administrative concerns suggest that some consumer services—or, more specifically, some consumer service providers—should not be taxable. In particular, the administrative costs and the enforcement problems associated with attempting to subject very small service providers, such as babysitters, housekeepers, and gardeners, to sales taxation are prohibitively large, while the revenue gains from doing so are quite small. On the other hand, there is no reason to exempt sufficiently large providers of such services (in this case, professional house cleaning services, professional landscapers) from the sales tax. Accordingly, the providers of such consumer services should be subject to the sales tax once their gross sales exceed a reasonable de minimis amount. In other words, the sales tax exemption should be based on the size of the provider, not the service delivered.

C. Taxing Consumer and Business Services

Of course, the current proposal in Florida, as well as attempts in other states to expand the base of the state sales tax to include services, do not adopt either of the two approaches described above. Instead, most current reform proposals, which are largely driven by the need to increase sales tax revenues without raising rates, would expand the tax base to include a wide variety of both consumer and business services, with only limited exemptions for the latter. The analysis thus far suggests that although there are some limited benefits from such an approach, the case for comprehensive coverage of both consumer and producer services under the sales tax is far weaker than the case for either of the reforms described above—

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increase. *See* Tatsuo Hatta, *Welfare Effects of Changing Commodity Tax Rates Toward Uniformity*, 29 J. PUB. ECON. 99, 104-07 (1986).

74. However, Bruce, Fox, and Murray note that sales tax paid on intermediate inputs tends to be a much higher portion of gross receipts in service industries than in manufacturing or in the wholesale and retail trade industries. Donald Bruce et al., *To Tax or Not to Tax? The Case of Electronic Commerce*, 21 CONTEMP. ECON. POL'Y 25, 31 (2003). That is, the taxation of intermediate inputs that occurs under current sales taxes results in a relatively large implicit sales tax burden on services. *See id.* Thus, a reform that would involve fully taxing consumer services, while not relieving the sales tax on business inputs, would likely result in over-taxation of consumer services.

fundamental reform of the sales tax system or the expansion of the base to include consumer services.

There is no doubt that taxing all services will increase revenues. For example, Fox and Murray estimate that, on average, the potential revenue increase from taxing selected services is 46.3% of sales tax receipts, with the increases ranging from 14% to 104%.[75] The largest increase in revenue comes from taxing the construction service industry, while taxing personal services contributes the least to additional revenue.[76] Note, however, that the efficiency effects of this revenue increase are far from clear, as taxing consumer services will generally improve efficiency but, as stressed above, taxing business services reduces efficiency.

Beyond its revenue effects, the benefits of taxing all services under the sales tax are basically the relatively small efficiency, equity, and simplicity gains enumerated in the previous Section that arise from including consumer services in the tax base. In addition, since many nonservice business inputs are currently taxed, taxing business services may improve efficiency by reducing the distortions of input choices businesses face under the sales tax.

However, taxing services under the sales tax has some significant disadvantages. Moreover, many of the advantages of taxing consumer services are not enhanced, and indeed may be offset, by taxing business services under the sales tax. Most importantly, as stressed above, taxing business services under the sales tax is generally highly undesirable, as it results in inefficient tax pyramiding which (1) distorts consumer choices and firm input decisions; (2) inefficiently encourages vertical integration to avoid the tax (and thus creates a tax bias favoring the large firms that can more easily achieve vertical integration);[77] (3) distorts firm location decisions; (4) hampers exports and; (5) discourages investment within the state by moving the tax system further away from one based on consumption.

Introducing comprehensive taxation of both consumer and business services is very likely to exacerbate the problems associated with the taxation of business inputs under the current system. This is because a significant fraction of the services added will be business services, even in comparison to the large degree of taxation of business inputs that occurs under the current system. For example, a rough calculation using 1997 Bureau of Economic Analysis input-

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75. Fox & Murray, *supra* note 1, at 25-26 tbl.3.

76. *Id.*

77. Indeed, the problems with inefficient tax-induced vertical integration may be particularly great with sales taxation of business services, because such vertical integration may be easier to achieve with services, which can readily be provided in-house, than with goods. *See* Fox & Murray, *supra* note 1, at 28-29; Hellerstein, *supra* note 5, at 8.

output data on the business and consumer shares of various services suggests that the business share of the increase in tax base that would occur under a comprehensive expansion of the sales tax base to both business and consumer services of the type envisioned in Florida would be slightly under sixty-five percent.[78] This figure is significantly larger than Ring's estimate that under the current sales tax system the average fraction of the sales tax base that consists of business inputs is forty percent.[79] Similarly, Quick and McKee report that the business share of the increase in revenue that would have occurred under Florida's 1987 sales tax on services was estimated to be eighty percent,[80] and Holcombe suggests (in this Forum) that the business share of revenues under the current Florida proposal would be in the range of sixty percent or more.[81] Thus, it seems very likely that adding both consumer and business services to the tax base would significantly increase, even in relative terms, the extent to which the sales tax applies to business inputs, and thus worsen all the problems associated with taxing business inputs.

Another important issue is whether adding business services to the tax base is likely to improve the revenue stability of the sales tax system. The previous discussion suggested that adding consumer services to the sales tax base would increase revenue stability in the presence of economic growth. However, this effect may currently be modest because consumption of personal services, relative to personal consumption, is no longer increasing as dramatically as in the past. The data presented in Table 2 suggest that adding both business and personal services to the sales tax base will not have much of an impact on revenue stability in the presence of economic growth, as the fraction of total services to gross domestic product has held fairly steady between fifty and fifty-five percent over the last twenty years or so, and has declined somewhat in recent years.[82]

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78. This prototypical calculation, which follows Siegfried & Smith, *supra* note 50, at 42-48, compares newly taxable business services to the sum of new taxable businesses and consumer services less health, education, and housing services which are assumed to be exempt. In this analysis, electricity and gas services, restaurant/bar services, radio/TV broadcasting services, hotel services, and retail trade services are considered to be taxable prior to the reform. U.S. CENSUS BUREAU, 1997 ECONOMIC CENSUS tbl.14 (2000), *available at* http://www.census.gov/prod/ec97/e97cs-8.pdf (last visited Nov. 18, 2002) (on file with author).

79. Ring, *supra* note 60, at 81 tbl.1.

80. Quick & McKee, *supra* note 5, at 405.

81. Randall G. Holcombe, *Taxing Services*, 31 FLA. ST. U. L. REV. 467, 471 (2003).

82. Holcombe reaches a similar conclusion using data for Florida. *Id.* at 472-73. He notes that this result is largely attributable to the fact that, although employment is growing more rapidly in the service sector than in manufacturing, productivity is growing relatively more rapidly in manufacturing, with the net result that output levels in the two sectors are growing at similar rates. *Id.* at 472.

Table 2. Total Services as a Fraction of Real GDP[83]

Year	1960	1965	1970	1975	1980	1985	1990	1995	2000
Total Services / GDP	.538	.532	.558	.569	.549	.544	.550	.543	.520

The discussion above also indicates that adding consumer services to the sales tax would have a positive effect on the revenue stability of the sales tax with respect to the business cycle, as consumption, especially of consumer services, tends to be more stable than income. However, it is important to note that this revenue stability argument does not necessarily extend to business services. Indeed, business purchases of many services such as advertising seem likely to be highly pro-cyclical, so that adding them to the sales tax base would, if anything, act to offset the revenue stability benefits of taxing consumption services.[84] Thus, arguments related to revenue stability over the business cycle provide a rationale for the two reform packages described above (comprehensive sales tax reform and taxing consumer services), but should not be used to support the taxation of business services or, to a lesser extent, comprehensive taxation of all consumer and business services.[85]

Taxing business services under the sales tax raises several additional rather contentious issues that would complicate any attempts to enact such a reform. As in the case of tangible goods, consistent application of the tax to services requires that services purchased outside the taxing state but used in the state should be subject to the use tax.[86] Uniform application of the use tax is required to avoid creating a tax bias favoring purchases from out-of-state vendors and thus to avoid discriminating against in-state service providers and thereby encouraging out-of-state relocations.[87] However, attempting to accomplish this may be even more difficult for business services than in the case of tangible goods, since in many cases an out-of-state service provider will not have nexus within the taxing state, and

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83. These figures were obtained from the Bureau of Economic Analysis, *National Income and Product Accounts*, at tbl. 1.4, *available at* http://www.bea.gov/bea/dn/nipaweb/TableViewFixed.asp#Mid (last visited Nov. 18, 2002) (on file with author).

84. *See* Quick & McKee, *supra* note 5, at 402.

85. Note also that the argument that taxing consumer services may improve the vertical equity of the sales tax because high income individuals tend to be disproportionately large consumers of services does not apply to the taxation of business services. The effect of taxing business services will appear as differential commodity prices and factor returns whose distributional effects could be determined only with an explicit general equilibrium analysis.

86. For elaboration of this point, see Hellerstein, *supra* note 5, at 8-9.

87. *Id.*

monitoring imports of services—especially digitized services—is exceedingly difficult. This will create a powerful incentive for businesses to purchase services from out-of-state vendors. Moreover, previous experience in Florida and elsewhere suggests that a wide variety of legal issues will arise and have to be resolved if the use tax is applied to sales of business services.[88]

A closely related issue is that for some sectors, including telecommunications (which would not be taxed under the Florida proposal), locating the jurisdiction in which services are consumed is fairly arbitrary for transactions that span two or more states, complicating collection of sales and use taxes. Interstate transportation services (which would be taxed under the current Florida proposal) are prone to the same difficulties. Determining the jurisdiction(s) in which such transactions should be taxed is inherently complicated, and this task is certain to give rise to contentious debates among the businesses and states involved.

Comprehensive taxation of services also introduces a variety of legal issues that do not arise with the taxation of tangible personal products, as the addition of any services to the sales tax base will inevitably be disputed by taxpayers and will prompt legal challenges.[89] For example, the 1987 law in Florida gave rise to claims that sales taxation of business services violated the First Amendment, which prohibits the state from discriminating against interests such as freedom of speech (taxation of advertising services).[90] Other legal objections to the new law included supposed violations of due process (taxation of advertising services) and equal protection guarantees (taxation of legal services).[91]

In addition, government administrative and enforcement costs would increase with expansion of the sales tax to include services,[92] as would compliance costs incurred by vendors, especially for those who previously paid no sales tax and are now included in the sales tax system.[93] These cost increases may be relatively large, as revenues net of administrative costs tend to be lower for service-oriented

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88. *See, e.g.*, *id.* at 13-14.

89. *See* Fox & Murray, *supra* note 1, at 31.

90. *See* Hellerstein, *supra* note 5, at 10-12.

91. *See id.* at 12-14. Note that the latter issue arises for consumer legal services as well. Since the 1987 act in Florida was quickly overturned, the Florida Supreme Court did not officially rule on these taxpayer complaints. However, in an advisory opinion to the governor, the court indicated that it was not convinced by the taxpayer arguments. Hellerstein, *supra* note 5, at 12.

92. For example, in Florida in 1987, 240 positions were created in the Department of Revenue to handle the administrative workload for the new tax system, resulting in a $6 million budget increase. *See* Fox & Murray, *supra* note 1, at 32.

93. *Id.* at 33.

firms than for retail firms.[94] On the other hand, for vendors who already sell both taxable goods and previously untaxed services, compliance costs would most likely decrease, as the need to separate taxable and nontaxable items would be eliminated.[95]

VI. CONCLUSION

The basic message of this Article is clear. There is a strong case for the taxation of consumer services as part of a fundamental reform of a state sales tax structure that would move it in the direction of a comprehensive, uniform tax on personal consumption, with as few exemptions as possible. Under such an approach, all business inputs, including business services, would be exempt from tax. Distributional concerns would be addressed with expenditure policy, a progressive state income tax, or means-tested sales tax rebates, rather than exemptions under the sales tax. Such an approach would be desirable from the viewpoint of a single state, and indeed could be promoted as a pro-growth policy. Moreover, if adopted by a large group of states, such an approach might well simplify the sales tax system to a sufficient extent that either congressional or judicial action would result in the imposition of a general requirement on remote vendors to collect use tax, eliminating the distortions and inequities that arise when most sales from remote vendors are effectively tax-exempt.[96]

Of course, the enactment of such a sweeping reform is unlikely in most, if not all, states. Nevertheless, the more modest approach of expanding the sales tax base to include more consumer services is also worthwhile to the extent that it is possible to do so without incurring prohibitively large administrative costs. Although the gains in economic neutrality, equity and simplicity, as well as the revenue increases, from such a reform would fall far short of those potentially attainable under the more fundamental reform described above, taxing consumer services would nevertheless result in an improved sales tax system. Moreover, such gains would be augmented to the extent the system was simultaneously reformed in the direction of reducing taxation of business inputs.

By comparison, the case for expanding the tax base to include business services—or, to a somewhat lesser extent, to include both consumer and business services—is much weaker. Most of the gains from taxing services arise from taxing consumer services, and are not enhanced, and indeed may be offset, by extending the sales tax to business services. In general, the primary effect of taxing business

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94. *See id.* at 32 n.5.
95. *Id.*
96. *See* McLure, *supra* note 24, at 104.

services is to exacerbate the problems of existing sales taxes. In particular, tax pyramiding, and its many associated inefficiencies, would in all likelihood increase significantly, and the other efficiency, equity, simplicity, and revenue stability implications of such a reform are also generally negative. Expanding the tax base to include consumer and business services would allow rate reductions that might reduce the cost of some of the inefficiencies associated with sales taxation, and taxing business services under a system that already taxes a great deal of business inputs might reduce existing distortions of input choices. It seems unlikely, however, that these gains would be sufficiently large to offset the many costs of increasing taxation of business services detailed above, so that such a reform should be approached with great caution.