broadening the sales tax base
dos & don'ts

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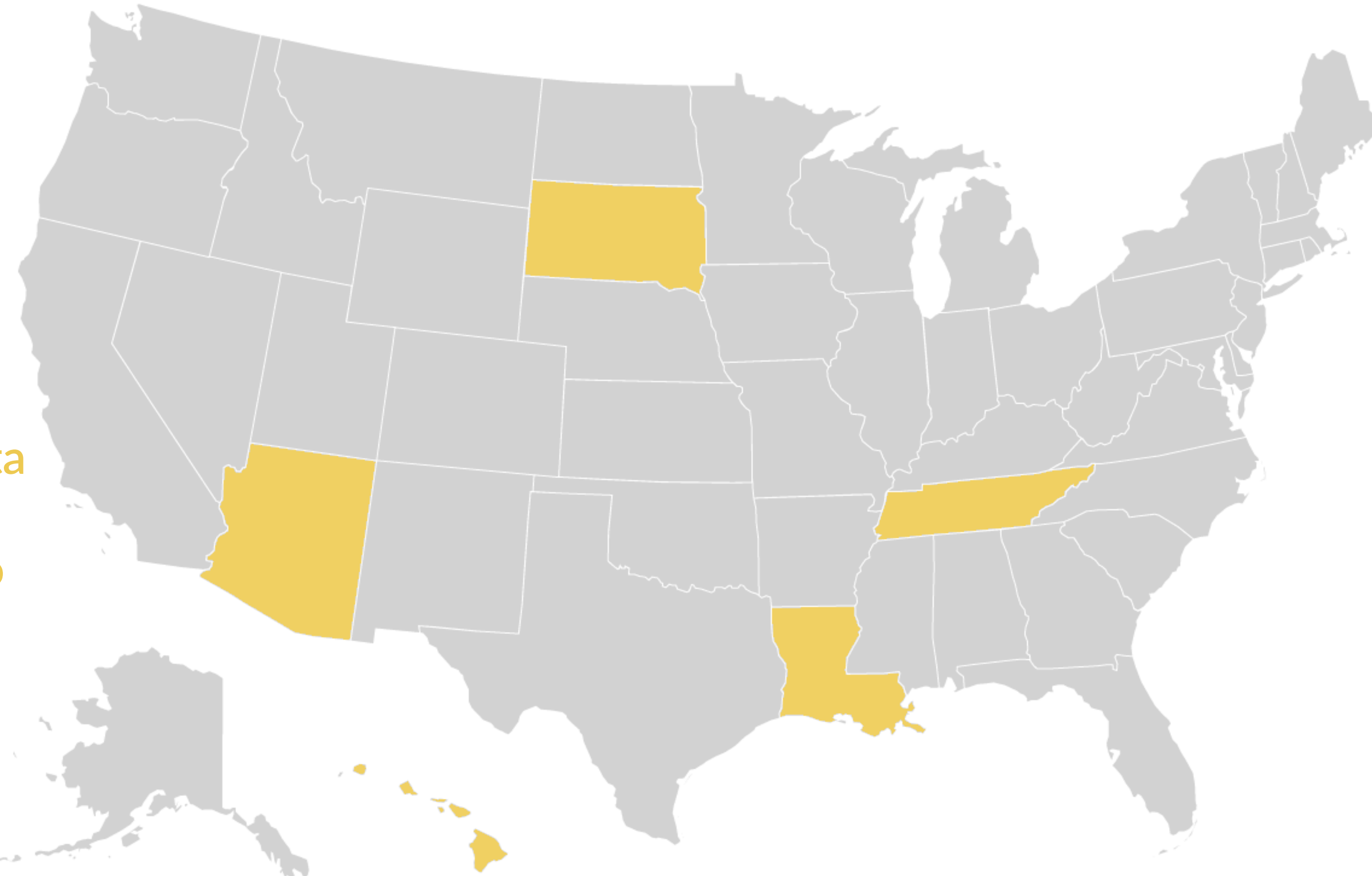
today, we'll cover:

- ☑ the (smart) rationale for sales tax base expansion
- ☑ things you should tax
- ☑ things you shouldn't
- ☑ why you shouldn't tax those things
- ☑ how states score on this metric

a little background:

which states rely **most** & least on sales taxes?

Tennessee
South Dakota
Louisiana
New Mexico
Hawaii

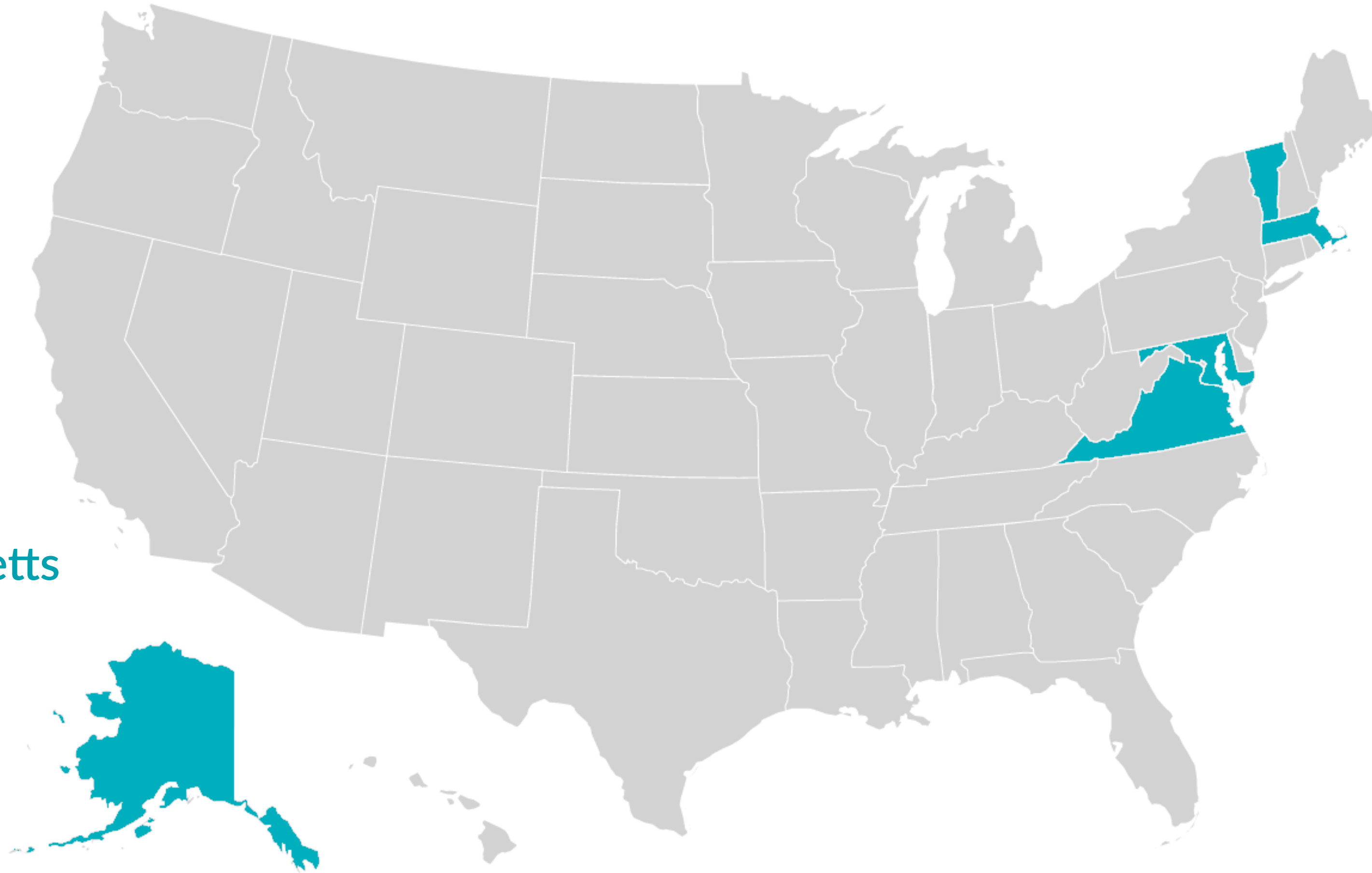


(based on percent of total state + local tax collections from sales taxes)

a little background:

which states rely most & **least** on sales taxes?

Alaska
Vermont
Maryland
Massachusetts
Virginia



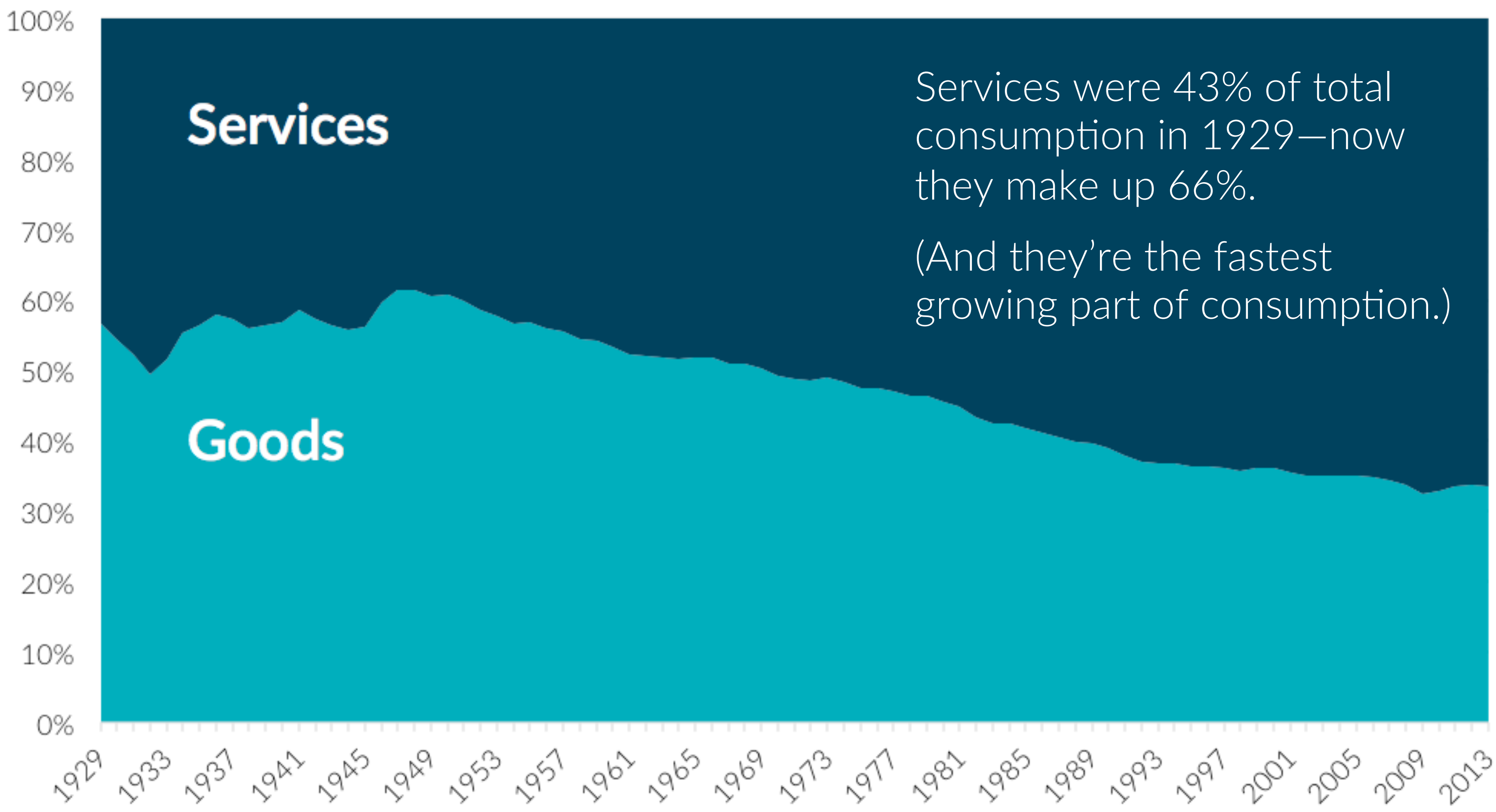
(based on percent of total state + local tax collections from sales taxes)

the rationale for base expansion

- ☑ why the push to expand the sales tax base?
- ☑ by standing still, the base is shrinking simply due to changing consumption patterns
- ☑ **goods consumption has gotten smaller, while services consumption has gotten bigger**

personal consumption expenditures

U.S. total, by percent of total PCE (1929-2013)



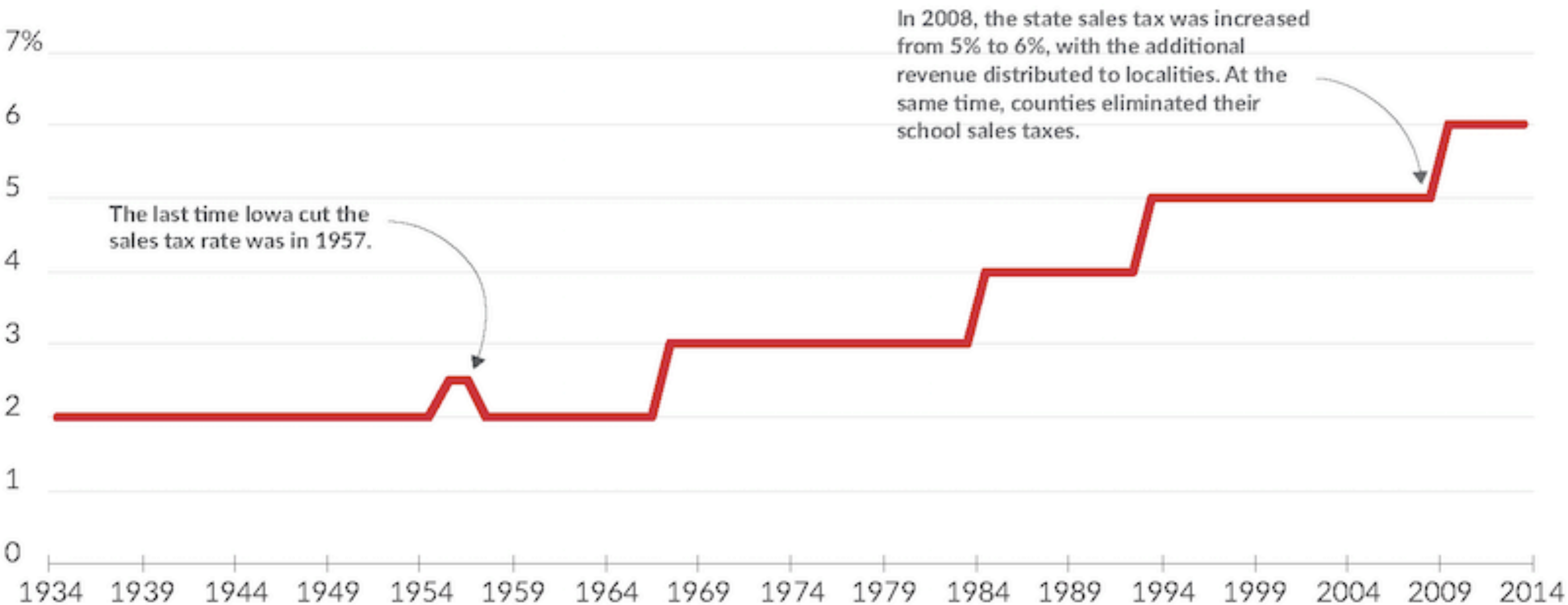
the rationale for base expansion

- ☑ why the push to expand the sales tax base?
- ☑ by standing still, the base is shrinking simply due to changing consumption patterns
- ☑ goods consumption has gotten smaller, while services consumption has gotten bigger
- ☑ **most state sales taxes are stuck where they started: taxing goods, ignoring services**

why does this matter?

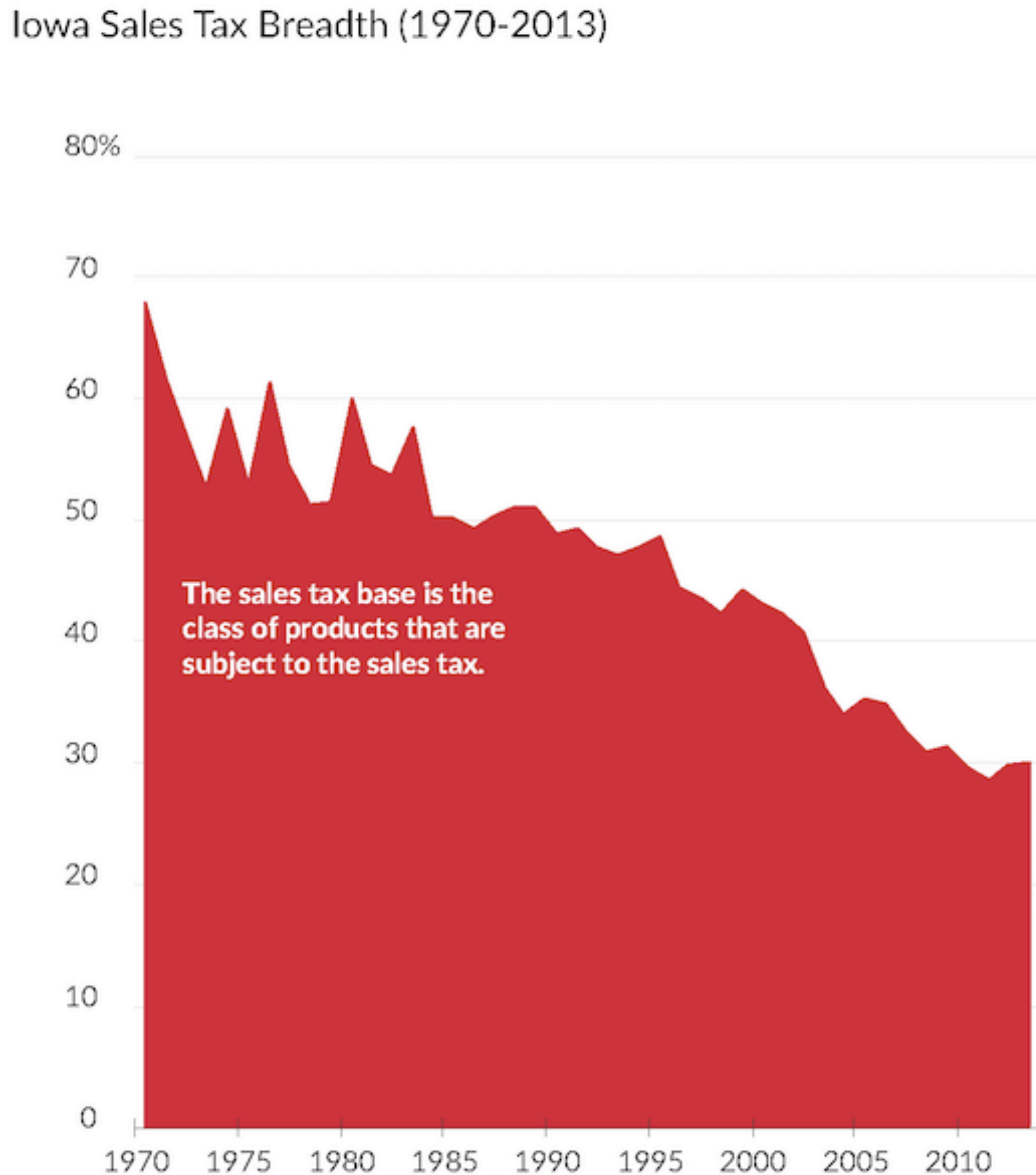
- ☑ if you're taxing a small number of things, **your rate has to be higher to make up for it** example:

Iowa



Source: Iowa Department of Revenue; Tax Foundation Fiscal Fact No. 420, *State and Local Sales Tax Rates in 2014*.

example:
Iowa



Source: Professor John Mikesell (Indiana University), Tax Analysts Special Report, *State Retail Taxes in 2012: The Recovery Continues* (2013).

Note: Sales tax breadth is defined as the ratio of the implicit sales tax base to state personal income.

why does this matter?

- ☑ if you're taxing a small number of things, your rate has to be higher to make up for it
- ☑ otherwise, you get less revenue
- ☑ it's often politically easier to increase the rate than to add historically exempt transactions to the base (that is, services)
- ☑ but rates can only be increased so much—
  at some point, service expansion is inevitable

dos & don’ts

- ☑ what should be in the base:
  goods and services purchased by final consumers

- ☑ what shouldn’t be in the base:
  goods and services purchased by businesses that will be used in the production process

but aren't special carve-outs supposed to be poor policy?

- ☑ not all exemptions are created equal
- ☑ sales tax exemptions for businesses ≠special treatment, but a structural feature that should be included in a well-structured tax code
- ☑ sales taxes on business inputs create a whole mess of problems

sales tax on business inputs leads to:

- ☑ arbitrary & hidden differences in effective sales tax rates on different goods, services, & industries **(distorts consumer choices)**

“tax pyramiding”

shorter production chains:
lower effective tax rate

“tax pyramiding”

longer production chains:
higher effective tax rate

sales tax on business inputs leads to:

- ☑ arbitrary & hidden differences in effective sales tax rates on different goods, services, & industries (distorts consumer choices)

- ☑ incentivizes businesses to vertically integrate, even if it doesn't make business sense **(distorts business choices)**

sales tax on business inputs leads to:

- ☑ arbitrary & hidden differences in effective sales tax rates on different goods, services, & industries (distorts consumer choices)
- ☑ incentivizes businesses to vertically integrate, even if it doesn’t make business sense (distorts business choices)
- ☑ less competitive business tax climate than other states **(can encourage businesses to relocate)**

why hasn't anybody done it yet?

- ☑ expanding tax to cover popular consumer consumer services = politically tough

In 2009, when faced with a proposal to apply the sales tax to legal services, the State Bar of Wisconsin sent a letter to the Governor claiming,

"Sales taxation of legal services is a tax on justice itself."

When DC was debating a proposal this year to moderately expand the sales tax base as part of a much larger (plan that included income tax cuts), Vida Fitness proclaimed,

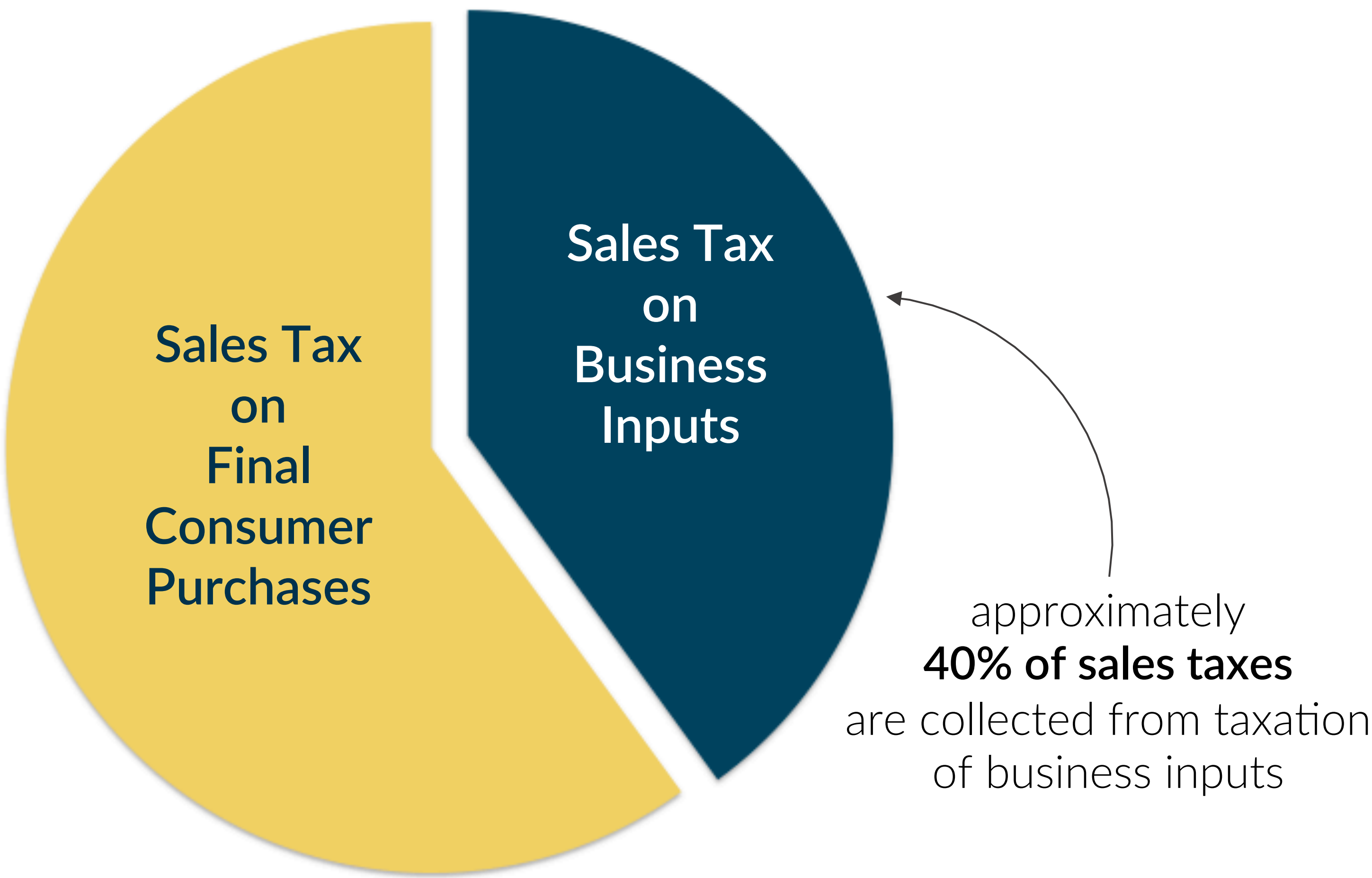
“VIDA plans to lobby against the fitness tax as we do not believe DC residents should be monetarily penalized for being healthy.”

why hasn't anybody done it yet?

- ☑ expanding tax to cover popular consumer consumer services = politically tough
- ☑ tough to define the (new, broader) tax base
- ☑ administration hurdles (sourcing, setup, audits)
- ☑ what about those "it depends" services that could be business services or consumer services, depending on who buys them?
- ☑ taxes on business inputs = easy revenue grab

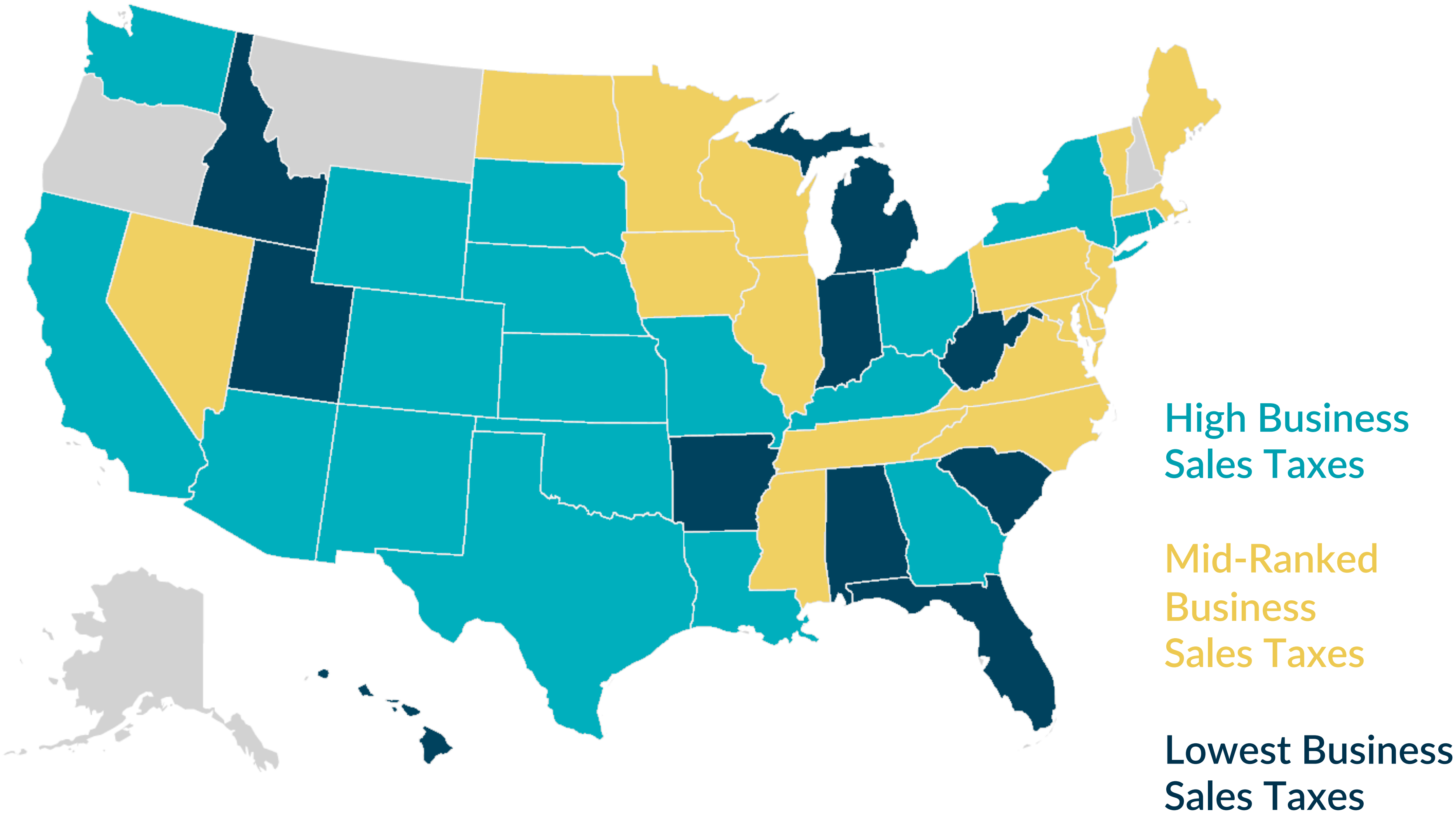
states tend to tax business inputs

based on percent of total sales taxes collected



Source: Council on State Taxation & Ernst & Young

share of sales tax on business purchases



Source: Council on State Taxation & Ernst & Young several lessons learned in 2013

Louisiana

Nebraska

Minnesota

Ohio

Massachusetts