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Timothy R. Hurley

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Curing the Structural Defect in State Tax Systems: Expanding the Tax Base to Include Services

by Timothy R. Hurley*

I. INTRODUCTION

“The state retail sales tax in America can be likened to an illegitimate child that was not wanted but that came anyway.”¹ At least that is how one economist has described the sales tax. He went on to state, “Being unwanted is not really unusual and it is certainly no bar to normal growth. It is even possible for the illegitimate to gain respectability.”² Apparently, the sales tax has gained respectability.³ Less than eighty years ago, there was no such tax in the United States.⁴ In 1932 Mississippi introduced what is the modern-day sales tax.⁵ Since then, forty-four states have enacted some version of a retail sales tax with Vermont the last in 1969.⁶ Today, there are five states without a sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon.⁷

Economists measure the respectability of the sales tax not only by its explosive growth, but also by the amount of revenue it contributes to the

* Assistant Professor of Business Law, Salisbury University. The Ohio State University (B.S., 1997); Ashland University (M.B.A., 2003); Washburn University School of Law (J.D., 2008); New York University School of Law (LL.M. in Taxation, 2009).

1. DANIEL C. MORGAN, JR., RETAIL SALES TAX: AN APPRAISAL OF NEW ISSUES 3 (1964).

2. *Id.*

3. *Id.*

4. *See id.*

5. William F. Fox, *Importance of the Sales Tax in the 21st Century*, in THE SALES TAX IN THE 21ST CENTURY 1, 1 (Matthew N. Murray & William F. Fox eds., 1997).

6. *Id.*

7. *Id.*

states.⁸ In 2008 states collected \$240.4 billion in general sales tax, which was less than the \$279.1 billion states collected in personal income tax.⁹ If selective sales taxes are included, however, the total sales tax is \$357.3 billion, far exceeding the personal income tax.¹⁰ Beyond that, from the states' perspective, it is a relatively easy tax to administer because vendors collect the tax from consumers and then remit the funds directly to the state.

The sales tax, however, is not without its issues and nuances. For example, in New York, consumers pay the sales tax "on the purchase of baseball tickets, Prell shampoo, non-sterilized cotton' [sic] and hot nuts, but not on the purchase of Broadway tickets, Head & Shoulders shampoo, sterilized cotton, or cold nuts (until recently, large marshmallows were taxable whereas small marshmallows were exempt)."¹¹ Probably one of the most peculiar characteristics of the sales tax is that states, for the most part, exclude services from the sales tax.¹² For example, states generally charge sales tax for the purchase of a lawnmower but not a lawn service. Likewise, they charge sales tax for laundry detergent and movies purchased at a store but not laundry services and Pay-Per-View movies watched at home.

When enacting the sales tax, states excluded services from taxation largely because, in those times, goods dominated the economy.¹³ Times have changed. Services now dominate the economy,¹⁴ but states still do not tax services to a wide extent.¹⁵ This structural defect in state taxing systems causes a substantial gap between needed revenue and actual revenue. This Article explores the sales tax, its history, and its structural defect. The Article advocates expanding the tax base to include services to cure the structural defects in state taxing systems.

8. *See id.*

9. U.S. Census Bureau, State Government Tax Collections: 2008, <http://www2.census.gov/govs/statetax/08staxss.xls> (last visited Jan. 13, 2010).

10. *Id.* Selective sales taxes are state excise taxes on alcoholic beverages, motor fuel, tobacco, and other selected items. *Id.*

11. 1 RICHARD D. POMP, STATE AND LOCAL TAXATION 6-10 to 6-11 (6th ed. 2009).

12. *Id.* at 6-26.

13. *See id.* at 6-26 & n.104.

14. *See infra* text accompanying notes 140–42.

15. *See infra* text accompanying notes 144–50.

II. SALES TAX

A. *In General*

In 2008 states collected \$240.4 billion in sales tax, not quite the \$279.1 billion states raised from the state personal income tax.¹⁶ The margin between these revenue producers, \$38.7 billion, is considerable and has been growing in recent years. For example, in 2007 state sales tax yielded \$238.0 billion while the personal income tax yielded \$265.7 billion—a difference of \$27.7 billion.¹⁷ Likewise, there was a considerable difference in 2006 when the state sales tax provided \$229.6 billion while the personal income tax provided \$293.1 billion—a difference of \$63.5 billion.¹⁸ This, however, has not always been the case. In fact, 1998 was the first year in the last half-century when the state personal income tax exceeded the state sales tax.¹⁹ In 1997, for example, the sales tax yielded \$147.4 billion while the personal income tax yielded \$145.0 billion.²⁰ The sales tax regained its status as the largest source of state tax in 2003 and 2004 but has not held that position since that time.²¹

Table 1 presents the sales tax yield by state for 2008. On average states realized about 30.8% of their tax revenue from the sales tax.²² Their reliance, however, varied. States without a personal income tax rely heavily on the sales tax,²³ including Washington (63.2%), Florida (60.0%), Tennessee (59.2%), South Dakota (55.4%), Nevada (50.3%), and

16. U.S. Census Bureau, State Government Tax Collections: 2008, *supra* note 9.

17. U.S. Census Bureau, State Government Tax Collections: 2007, <http://www2.census.gov/govs/statetax/07staxss.xls> (last visited Jan. 13, 2010).

18. U.S. Census Bureau, State Government Tax Collections: 2006, <http://www2.census.gov/govs/statetax/06staxss.xls> (last visited Jan. 13, 2010).

19. POMP, *supra* note 11, at 6-1.

20. U.S. Census Bureau, State Government Tax Collections: 1997, <http://www2.census.gov/govs/statetax/97staxss.xls> (last visited Jan. 13, 2010).

21. POMP, *supra* note 11, at 6-1; U.S. Census Bureau, State Government Tax Collections: 2003, <http://www2.census.gov/govs/statetax/03staxss.xls> (last visited (Jan. 13, 2010)); U.S. Census Bureau, State Government Tax Collections: 2004, <http://www2.census.gov/govs/statetax/04staxss.xls> (last visited Jan. 13, 2010).

22. Federation of Tax Administrators, 2008 State Tax Collection by Source, <http://www.taxadmin.org/fta/rate/08taxdis.html> (last visited Jan. 31, 2010). In 1949 and 1950, the sales tax yielded 23.9% and 21.1%, respectively, of the total state tax revenue. John F. Due, *Retail Sales Taxation in Theory and Practice*, 3 NAT'L TAX J. 314, 314 (1950). In 1995 the sales tax yielded about 35% on average. John L. Mikesell, *The Future of American Sales and Use Tax*, in THE FUTURE OF STATE TAXATION 15, 16 (David Brunori ed., 1998).

23. Mikesell, *supra* note 22, at 16.

Texas (48.5%).²⁴ Wyoming, however, has no personal income tax and raised only 34.3% of its tax revenue from its sales tax, but Mississippi, a state that has a personal income tax, raised 47.4% from its sales tax.²⁵

Generally, “[s]tates in the Northeast rely less on the sales tax than do those in the West.”²⁶ For example, compare New York (17.3%), Massachusetts (18.8%), and Vermont (13.3%) with Arizona (46.9%), Idaho (36.9%), and New Mexico (34.4%).²⁷ One commentator notes that

[t]here is no ideal mix of taxes that could, or should, be prescribed to states; the mix in any given state is a product of peculiarities of the state’s economy, choices in the design of particular taxes to be broad or narrow, and the history of politics of each state.²⁸

There are, however, some certainties among the state sales taxes. For example, states receive large amounts of revenue from sales taxes that have relatively low statutory rates, enjoy a relatively low administrative burden because the collection and remittance by vendors is simple, and face little public objection.²⁹

Table 1: Sales Tax Yield by State for 2008³⁰

	Tax Revenue from Sales Tax (in Thousands of Dollars)	Percentage of Total Tax Revenue
Alabama	\$2,285,892	25.2%
Alaska	-	0%
Arizona	\$6,428,114	46.9%
Arkansas	\$2,809,063	37.3%
California	\$31,922,464	27.2%
Colorado	\$2,310,000	24.0%
Connecticut	\$3,181,584	23.8%
Delaware	-	0%

24. Federation of Tax Administrators, 2008 State Tax Collection by Source, *supra* note 22.

25. *Id.*

26. Mikesell, *supra* note 22, at 16.

27. Federation of Tax Administrators, 2008 State Tax Collection by Source, *supra* note 22.

28. Mikesell, *supra* note 22, at 16.

29. *Id.*

30. Table 1 was adapted from data available through the Federation of Tax Administrators. See Federation of Tax Administrators, 2008 State Tax Revenue, <http://www.taxadmin.org/fta/rate/08taxbur.html> (last visited Jan. 31, 2010); Federation of Tax Administrators, 2008 State Tax Collection by Source, *supra* note 22.

Florida	\$21,510,000	60.0%
Georgia	\$5,800,377	31.9%
Hawaii	\$2,619,823	50.9%
Idaho	\$1,347,588	36.9%
Illinois	\$7,940,859	24.9%
Indiana	\$5,742,660	38.5%
Iowa	\$1,840,164	26.7%
Kansas	\$2,262,560	31.6%
Kentucky	\$2,876,016	28.6%
Louisiana	\$3,455,256	31.4%
Maine	\$1,071,462	29.1%
Maryland	\$3,752,956	22.6%
Massachusetts	\$4,105,168	18.8%
Michigan	\$8,227,624	33.2%
Minnesota	\$4,543,608	24.8%
Mississippi	\$3,136,932	47.4%
Missouri	\$3,223,710	29.4%
Montana	-	0.0%
Nebraska	\$1,532,225	36.7%
Nevada	\$3,076,348	50.3%
New Hampshire	-	0.0%
New Jersey	\$8,909,547	29.1%
New Mexico	\$1,952,200	34.4%
New York	\$11,314,200	17.3%
North Carolina	\$5,262,411	23.1%
North Dakota	\$529,448	22.9%
Ohio	\$7,859,452	29.8%
Oklahoma	\$2,095,548	24.7%
Oregon	-	0.0%
Pennsylvania	\$8,866,224	27.6%
Rhode Island	\$847,627	30.7%
South Carolina	\$3,052,255	36.1%
South Dakota	\$731,834	55.4%
Tennessee	\$6,830,496	59.2%
Texas	\$21,667,860	48.5%
Utah	\$1,961,850	33.0%
Vermont	\$338,352	13.3%
Virginia	\$3,663,192	19.9%
Washington	\$11,341,240	63.2%
West Virginia	\$1,107,533	22.7%
Wisconsin	\$4,270,187	28.3%
Wyoming	\$743,624	34.3%

B. *Fundamentals of the Sales Tax*

The retail sales tax varies from state to state in its statutory scheme and its terminology.³¹ The various sales tax statutes, however, have a similar theme. States generally design the sales tax to be a uniform tax that applies to a wide range of personal consumption expenditures.³² In addition, the sales tax should shift to the ultimate consumer and apply to the amount actually paid by that consumer.³³ This shift underscores the sales tax's underlying philosophy of "distribut[ing] shares of the costs of government according to consumption expenditure."³⁴

Professor John Due describes these rationales as follows:

If a sales tax is to be a truly general consumption tax, it should apply to all expenditures for personal consumption purposes but not to any transactions involving use in business activity. Exclusion of any personal consumption purchases favors those persons with disproportionate expenditures on these goods, leads to economic distortions by shifting purchases and production from taxed to untaxed goods, reduces revenue at given rates, and, as is well-known, complicates compliance and administration. Inclusion of purchases for production purposes is contrary to the philosophy of the tax, results in haphazard and uncertain distribution of the tax burden, affects choice of production processes, and, from a state's standpoint, may adversely affect economic development.³⁵

Inherent in Professor Due's description of the sales tax is the concept that not all sales should trigger a tax.³⁶ Under the sales tax, the focus on consumption means that states should exempt from the sales tax any purchases by a business, even the prosperous ones.³⁷ Nevertheless, an empirical study by Professor Raymond Ring indicated that the average

31. POMP, *supra* note 11, at 7-1.

32. Due, *supra* note 22, at 315; *see also* JOHN F. DUE, STATE AND LOCAL SALES TAXATION: STRUCTURE AND ADMINISTRATION 24 (1971).

33. DUE, *supra* note 32, at 24.

34. John L. Mikesell, *Sales Tax Coverage for Services—Policy for a Changing Economy*, 9 J. ST. TAX'N 31, 32 (1991).

35. *Id.*

36. *See* POMP, *supra* note 11, at 7-1.

37. Mikesell, *supra* note 22, at 20. Professor John Mikesell states that "the taxability of a purchase should depend on whether the purchaser is a household or a business, not on the nature or prosperity of the seller and not on whether the sale is of a good or a service." *Id.*

state's sales tax comprised 59% sales to households and 41% sales to businesses.³⁸

The structures of all retail sales tax statutes at a minimum apply to tangible personal property, unless specifically exempted.³⁹ The usual practice of the sales tax statute is to sweep all sales into the "retail sales net" and then to exclude specific transactions.⁴⁰ Most sales tax statutes, therefore, define a *retail sale* as "a sale of tangible personal property for any purpose except for resale."⁴¹ The definition of *retail sale*, therefore, eliminates inventory from taxation, and inventory is a major class of sales to businesses.⁴² The statutes also define *tangible personal property* generally as "personal property that may be seen, weighed, measured, felt, or touched or which is in any manner perceptible to the senses."⁴³

Probably the most important definition that a retail sales tax statute provides is that of a *sale*. The occurrence of a sale is the only transaction that triggers the tax.⁴⁴ States typically use a similar definition of sale.⁴⁵ The following is representative of the definition of sale in all states' statutes:

Any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume (including, with respect to computer software, merely the right to reproduce), conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any

38. William F. Fox, *Can the State Sales Tax Survive a Future Like Its Past?*, in THE FUTURE OF STATE TAXATION, *supra* note 22, at 33 (citing Raymond J. Ring, Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*, 42 NAT'L TAX J. 167, 175 (1989)).

39. POMP, *supra* note 11, at 7-1.

40. *Id.*

41. *Id.*

42. *Id.* This is often referred to as the "purchase for resale exemption" or the "sale for resale exemption." *Id.*

43. *Id.* The following statute is an example of a retail sales tax statute and is representative of many other state statutes:

There is imposed and there shall be paid a tax of 7% upon: (a) The receipts from every retail sale of tangible personal property or digital property, except as otherwise provided in this act. (b) The receipts from every sale, except for resale, of the following services: (1) Producing, fabricating, processing, printing or imprinting tangible personal property or digital property, performed for a person who directly or indirectly furnishes the tangible personal property or digital property, not purchased by him for resale, upon which such services are performed.

N.J. STAT. ANN. § 54:32B-3 (West 2002 & Supp. 2009).

44. POMP, *supra* note 11, at 7-3.

45. *Id.*

agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor.⁴⁶

III. SALES TAX: A HISTORICAL PERSPECTIVE

The sales tax, in one form or another, existed throughout the world far before it found its home in the American economy. Basing a tax upon the sale of goods existed in the kingdoms of the ancient world.⁴⁷ For example, Greece, Egypt, India, China, Rome, and Byzantium imposed a tax on the sale of "imported goods, although [the tax] frequently extended to sales of domestic wares and chattels, including slaves."⁴⁸

Medieval Europe also utilized sales taxes.⁴⁹ The most widely discussed is the *alcavala* (or *alcabala*), which Spain utilized subsequent to the thirteenth century.⁵⁰ In 1776 Adam Smith described this tax in *The Wealth of Nations*⁵¹ as follows: "It was at first a tax of ten per cent., afterwards of fourteen per cent., and is at present of only six per cent. upon the sale of every sort of property, whether moveable or immoveable; and it is repeated every time the property is sold."⁵² Economists often cite the tax's "unpopularity and evil administration" as the catalyst for Spain's economic decline.⁵³

The sales tax never really gained high prominence until after World War I. By the end of World War I, the sales tax existed only in a few underdeveloped countries such as Mexico and the Philippines.⁵⁴ It, however, spread to many European nations between 1918 and 1923, mostly in response to financial systems suffering from war and uncontrolled inflation.⁵⁵ In these countries, taxpayer morale was low.⁵⁶ Therefore, nations implemented these, taxes as opposed to raising the rates on existing taxes because the sales tax could be hidden

46. N.Y. TAX LAW § 1101(b)(5) (McKinney 2008).

47. NEIL HERMAN JACOBY, *RETAIL SALES TAXATION: AN ANALYSIS OF ECONOMIC AND ADMINISTRATIVE PROBLEMS* 22 (1938).

48. *Id.* "One commentator described these ancient and medieval sales taxes as 'iniquitous in their collection, unjust in their burdens, and unpopular with taxpayers.'" POMP, *supra* note 11, at 6-3 (quoting ALFRED D. BUEHLER, *GENERAL SALES TAXATION: ITS HISTORY AND DEVELOPMENT* 5 (1932)).

49. JACOBY, *supra* note 47, at 23.

50. *Id.*

51. ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (Edwin Cannan ed., Univ. of Chi. Press 1976) (1776).

52. *Id.* at 431.

53. JACOBY, *supra* note 47, at 23; POMP, *supra* note 11, at 6-3.

54. POMP, *supra* note 11, at 6-3.

55. JACOBY, *supra* note 47, at 23; POMP, *supra* note 11, at 6-3.

56. JACOBY, *supra* note 47, at 23.

in the price of goods, collected through business channels, and paid in small increments on day-to-day purchases.⁵⁷

In the United States, the Great Depression wreaked havoc on the economy. The states, therefore, sought to gain additional revenue to meet demand for a property tax reduction.⁵⁸ As a result, the sales tax saw widespread growth in the states between 1933 and 1935.⁵⁹ At the time, the states considered these taxes temporary emergency measures.⁶⁰ States rationalized the tax as follows: "The depression reduced revenues from other taxes at the same time that relief needs were increasing, and participation in many federal programs of the period necessitated additional state expenditures."⁶¹ Economists, however, rejected the sales tax as "medieval anachronisms, . . . drawn up hastily, with little thought [as] to their exact aims beyond raising money, their economic effects, or the best structures in terms of the desired purposes."⁶² Nevertheless, states continued to copy the sales tax law of the pioneers, describing the tax as a necessary measure to raise revenue until the Great Depression was over and the tax eliminated.⁶³

In 1932 Mississippi introduced the first substantial retail sales tax,⁶⁴ followed closely by Pennsylvania.⁶⁵ Between 1933 and 1938, twenty-seven additional states enacted a sales tax.⁶⁶ As prosperity turned

57. *Id.* at 23–24.

58. Due, *supra* note 22, at 314.

59. *Id.* In 1934 Professor Robert M. Haig, mostly known for the Haig-Simons definition of *income* as consumption plus changes in wealth, described the spread of the sales tax. He stated,

When the World War was nearing its end in the middle of 1918, the sales tax as an important fiscal instrument was to be found only in a few small countries and in Germany, where the rate was but 0.1 per cent. Today, fifteen years later, the tax has spread over four continents, and is now an important element of national taxation in the larger part of Europe and South America, in Australia and Canada, and is rapidly assuming an important place as a state tax in the United States. In the history of public finance no other tax, save perhaps the one on gasoline, has spread so swiftly over the world.

ROBERT MURRAY HAIG ET AL., *THE SALES TAX IN THE AMERICAN STATES* 5 (1934).

60. POMP, *supra* note 11, at 6-4.

61. DUE, *supra* note 32, at 2–3.

62. Due, *supra* note 22, at 314.

63. *Id.* at 314–15.

64. JACOBY, *supra* note 47, at 61.

65. DUE, *supra* note 32, at 2. Pennsylvania allowed its sales tax to expire one year after its enactment. *Id.* The state's tax was reenacted in its permanent form in 1956. *Id.* at 3.

66. *Id.* Of the twenty-seven states, five—Idaho, Kentucky, Maryland, New Jersey, and New York—allowed the sales tax to expire within one or two years. *Id.* These states reinstated the sales tax as follows: Idaho in 1965, Kentucky in 1960, Maryland in 1947,

state financial troubles into financial surpluses, no state enacted the sales tax for almost ten years.⁶⁷ There was a renewed trend toward the sales tax beginning with the Tennessee sales tax in 1947.⁶⁸ By 1963 ten additional states had enacted the sales tax and three had reinstated an earlier repealed sales tax to bring the total number of states with a sales tax to thirty-seven.⁶⁹ By 1969 five additional states introduced a sales tax and three reinstated their sales tax, bringing the final total to its current status of forty-five.⁷⁰

IV. EVALUATION OF THE SALES TAX

Legislators defend the sales tax on pragmatic grounds because "[t]he tax raises substantial revenue in most states (some of it from businesses and nonresidents) in a manner that most voters [and legislators] apparently find acceptable."⁷¹ One of its advantages is that it is a less painful tax to consumers because it is collected bit by bit over a period of time on thousands of transactions.⁷² From the states' perspective, compared to the personal state income tax, the sales tax is relatively stable in economic downturns.⁷³ In addition, the significant revenue from the sales tax reduces the pressure on other taxes, such as the state income tax.⁷⁴ Because of the sales tax, states can have lower nominal rates on other taxes and still maintain the same level of government revenue.⁷⁵ Policy analysts believe that "[a] broad-based state tax structure with low nominal rates is . . . superior to one that relies on fewer taxes and higher nominal rates."⁷⁶

New Jersey in 1966, and New York in 1965. *Id.*

67. *Id.* at 4. In 1942 Louisiana reinstated the sales tax that it repealed in 1940. *Id.* No state with an existing sales tax, however, repealed it. *Id.*

68. *Id.* "[T]he . . . postwar levies arose out of the failure of other tax yields to keep pace with inflationary trends in prices and wage costs and continued pressure from property-owning groups for property tax relief." Due, *supra* note 22, at 315.

69. DUE, *supra* note 32, at 4.

70. *Id.* Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax. *Id.* at 5.

71. POMP, *supra* note 11, at 6-7.

72. *Id.*

73. *Id.* at 6-8. One of the reasons the sales tax is more stable than the income tax is that it is less volatile or more revenue inelastic. *See id.* at 6-8 n.32. "The income tax is more revenue elastic in part because of the progressive rates that most states use." *Id.* Additionally, "[a] tax that is revenue elastic can be volatile, with revenues increasing rapidly during periods of boom, and falling rapidly during downturns." *Id.*

74. *Id.* at 6-8.

75. *Id.*

76. *Id.*

Others defend the sales tax using a consumption tax-based argument, couching it in terms of equity.⁷⁷ In terms of ability to pay, they argue the retail sales tax “taxes persons based on their standard-of-living, as exhibited by their consumption of goods and services.”⁷⁸ Because states exclude basic necessities such as food, health care, housing, and education from the sales tax, consumers “have demonstrated an ability-to-pay by their decision to consume rather than save.”⁷⁹

John Mikesell, a well-known sales tax commentator, defends the sales tax as follows:

Household consumption is driven by each individual household’s own assessment of its capacity to afford goods and services provided by the private market. In a market economy, what more equitable standard would there be for dividing shares of the cost of government than exactly the shares of private goods and services that the household itself has decided that it can afford? The household consumption measure is a much more encompassing indicator of affluence than annual income because it is driven not only by income for the year but by accumulations from prior years and prospects for the future.⁸⁰

Thomas Hobbes formulated an early argument along these lines. The sales tax, as a consumption tax, taxes individuals on the amount of resources taken from society but does not tax those who choose to save because they are putting resources back into society.⁸¹ The sales tax, however, is not without its criticisms, some of which the next section addresses by analyzing the sales tax through the criteria used to evaluate any tax: fairness, efficiency, and revenue adequacy.

A. Fairness

In 1776 Adam Smith provided his view of tax fairness in *The Wealth of Nations*.⁸² Smith wrote, “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”⁸³ Economists and tax theorists later labeled this concept the

77. *See id.*

78. *Id.*

79. *Id.* at 6-8 to 6-9.

80. *Id.* at 6-9 (internal quotation marks omitted) (quoting John L. Mikesell, ‘States of Mind’: A Quality Index for State Sales Tax Structure—Measuring the States Against an Ideal Standard, STATE TAX TODAY (Jan. 26, 2005)).

81. *Id.* at 6-9.

82. *See SMITH, supra* note 51.

83. *Id.* at 350.

benefit principle.⁸⁴ The underlying premise of the benefit principle is that “fairness in taxation requires that taxpayers contribute in proportion to the benefit they derive from government.”⁸⁵ The implications of the benefit principle are unclear, however, because tax theorists lack the ability to determine an accurate measure of the benefits individuals receive from the government.⁸⁶ Therefore, Adam Smith’s benefit principle and other views of tax equity more or less collapsed into a “tax fairness structure that is comprised of two fairness norms.”⁸⁷ These fairness norms, which are corollaries of each other, are horizontal equity and vertical equity.⁸⁸ Tax theorists use horizontal and vertical equity to determine whether a tax or tax system is fair.⁸⁹

1. Horizontal Equity. Horizontal equity demands that “individuals with the same taxpaying capacity should pay the same amount of tax.”⁹⁰ The difficulty with applying this standard is that there is no uniform definition of *same*.⁹¹ For example, ability-to-pay supporters advocate that income should define what *same* means while others argue that consumption is the measure of “sameness.”⁹² If income is the measure of sameness, the sales tax generally discriminates against those persons who have a preference for consumption versus saving.⁹³ An example will help illustrate this concept:

Jeff and Teresa are two taxpayers who are alike in almost every way (each is married, each has two children, they live side-by-side in houses that they own, and so on). Both worked every day this year and earned a salary of \$10,000. With his \$10,000, Jeff purchased a new swimming pool for his house. Teresa saved her \$10,000. Because Jeff has a preference for consumption, the state imposes a tax, whereas Teresa has no such tax liability.

84. Richard J. Wood, *Supreme Court Jurisprudence of Tax Fairness*, 36 SETON HALL L. REV. 421, 422 (2006).

85. See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 16 (2002).

86. *Id.*

87. Wood, *supra* note 84, at 422; see MURPHY & NAGEL, *supra* note 85, at 20.

88. Wood, *supra* note 84, at 422.

89. *Id.* at 423 (citing Leo P. Martinez, “To Lay and Collect Taxes”: *The Constitutional Case for Progressive Taxation*, 18 YALE L. & POL’Y REV. 111, 123 (1999)).

90. GEORGE R. ZODROW, *STATE SALES AND INCOME TAXES: AN ECONOMIC ANALYSIS* 15 (1999).

91. *Id.*

92. POMP, *supra* note 11, at 6-10.

93. Due, *supra* note 22, at 316.

This preference for consumption also discriminates against large families that have to "spend a higher percentage of [their] income than smaller families of the same income level."⁹⁴

2. Vertical Equity. Vertical equity demands that "individuals with greater taxpaying capacity should pay a larger amount of tax."⁹⁵ Like horizontal equity, vertical equity has its criticisms as well. For example, vertical equity is subjective in that "people have widely diverging views on how the tax burden should vary with ability to pay."⁹⁶ In general terms, the issue from a vertical equity policy perspective is whether a tax should be proportional, progressive, or regressive.⁹⁷

A proportional tax is "the same percentage of income regardless of the amount of income"; a progressive tax is "an increasing percentage of income as income increases"; a regressive tax is a "decreasing percentage of income as income increases."⁹⁸ More specifically, when the sales tax is measured against income, it is regressive because as income levels rise, the sales tax remains the same percentage.⁹⁹ "For example, according to a [fairly] recent study, the twenty [percent] of families with the lowest income pay 5.9 percent of their income in sales tax, whereas the most affluent one percent of families pay just [one] percent of their income to paying the tax."¹⁰⁰

To combat issues of the perceived horizontal and vertical inequity in the sales tax, states often exempt many household consumption purchases from taxation.¹⁰¹ Other exemptions, however, represent political strength and the desire to support certain causes.¹⁰² Exemp-

94. *Id.* Professor Due points out that the sales tax is a means of collecting some tax from those who choose to evade the income tax because the sales tax is collected at the point of sale. *Id.*

95. ZODROW, *supra* note 90, at 15.

96. *Id.*

97. See POMP, *supra* note 11, at 6-14.

98. *Id.*

99. *Id.*

100. *Id.*

101. Mikesell, *supra* note 22, at 24.

102. *Id.* Besides political strength,

the following seven considerations underlie most exemptions and thus explain why the principle of horizontal equity is difficult to implement: (1) reducing the regressivity of the sales tax if measured by income; (2) reducing the absolute burden of the tax on the poor; (3) providing relief for a special hardship; (4) providing an incentive (even if only symbolic) for socially or economically desirable behavior; (5) reducing the administrative difficulty or expense of taxing a particular good or service; (6) responding to an exemption adopted by a neighboring state; or (7) reducing the sales tax burden on specific goods or services

tions can eliminate the tax on items purchased by low-income people.¹⁰³ In revenue terms, the most significant exemption, food for at-home consumption, excludes roughly 20% of the potential tax base.¹⁰⁴ The problem from an equity standpoint is that while lowering the tax on low-income people, it simultaneously benefits high-income people as well because the exemption applies to the product and not the person.¹⁰⁵ As one commentator notes, this reduction in regressivity

has considerable revenue cost, requires higher statutory rates to produce a given yield, reduces the stability of revenue in times of economic recession, complicates collection by forcing a distinction between food and nonfood items, favors households with a preference for expensive foods, and directs considerable tax relief to high- and middle-income families in an effort to help the poor.¹⁰⁶

Professor Richard Pomp notes that exemptions often work against the intended beneficiary.¹⁰⁷ He states that “[a] state with a 5% rate and no food exemption would have to increase its rate by around one percentage point, to 6%, to offset the revenue loss resulting from the adoption of a food exemption.”¹⁰⁸ This works against families that benefit from the food exemption because they would pay a 6% sales tax on all other purchases instead of a 5% sales tax.

B. Efficiency

Efficiency requires a tax system to be structured “to minimize the aggregate loss in individual welfare associated with raising a given

already subject to a selective excise or gross receipts tax, such as cigarettes, alcohol, or gasoline.

POMP, *supra* note 11, at 6-11.

103. POMP, *supra* note 11, at 6-10; *see also* Due, *supra* note 22, at 317.

104. Mikesell, *supra* note 22, at 24; *see also* DUE, *supra* note 32, at 65-66 (discussing food exemption); POMP, *supra* note 11, at 6-21 (same). “Twenty-five years ago, [twenty-eight] states taxed food. In 2008 [twelve] states fully taxed food, whereas [twenty-eight] (including the District of Columbia) fully exempted it and [eleven] taxed it at a reduced rate; all states, however, tax at least some restaurant meals.” POMP, *supra* note 11, at 6-15 (citation omitted). Of those states that tax food, six states—Hawaii, Idaho, Kansas, Oklahoma, South Dakota, and Wyoming—offer credits or rebates to reduce tax liability. Federation of Tax Administrators, *State Sales Tax Rates* (Jan. 1, 2008), <http://www.taxadmin.org/FTA/rate/sales.html>.

105. POMP, *supra* note 11, at 6-10. High-income people receive more than double the tax relief low-income people receive. Mikesell, *supra* note 22, at 24 (citing John L. Mikesell, *Should Grocery Food Purchases Bear a Sales Tax Burden?*, STATE TAX NOTES 751, 751-52 (Sept. 9, 1996)).

106. Mikesell, *supra* note 22, at 24.

107. *See* POMP, *supra* note 11, at 6-21.

108. *Id.*

amount of tax revenue."¹⁰⁹ Two factors contribute to such losses: (1) the loss in welfare due to the actual transfer of money to the government for the tax, and (2) the "excess burden," which is measured by the distortions between individuals and firm choices as individuals change their behavior to reduce tax liability.¹¹⁰ An efficient tax does "not interfere with decisions that would be made in a pre-tax world to work or to play, to save or to consume, to consume one good or service over another, or to use one production process rather than another."¹¹¹ All taxes distort behavior to some extent and discourage the activity upon which they are levied.¹¹² Therefore, the question is not which tax is efficient, but which tax is least inefficient.¹¹³

The retail sales tax distorts behavior in several ways. First, if all consumption is not taxed uniformly, the sales tax may distort choices among goods.¹¹⁴ For example, if two goods or services are equal in the satisfaction they provide to consumers but one is subject to sales tax whereas the other is exempt, the increased price from the tax may alter some consumers' purchasing decisions.¹¹⁵ Second, the sales tax may affect where an individual or business chooses to locate.¹¹⁶ For example, a person or business may choose to settle in a state like Delaware, which has no sales tax, to minimize the sales tax liability.

C. Revenue Adequacy

States must raise sufficient revenue to supply the services their residents require or eliminate those services altogether. Residents must have highways, roads, transportation, schools, health care, and police and fire protection.¹¹⁷ States must not only raise this revenue during

109. ZODROW, *supra* note 90, at 12.

110. *Id.* Commentators often couch efficiency in terms of neutrality. See POMP, *supra* note 11, at 6-14. "A tax that does not change the economic behavior of individuals and businesses is described as neutral." *Id.*

111. POMP, *supra* note 11, at 6-14.

112. *Id.*; ZODROW, *supra* note 90, at 13.

113. ZODROW, *supra* note 90, at 13.

114. POMP, *supra* note 11, at 6-14.

115. *Id.*; ZODROW, *supra* note 90, at 13. David Merriman and Mark Skidmore recently conducted an empirical study to determine whether sales tax contributed to the growth of the service sector. See David Merriman & Mark Skidmore, *Did Distortionary Sales Taxation Contribute to the Growth of the Service Sector?*, 53 NAT'L TAX J. 125, 125 (2000). The study concluded that the service sector has grown and that a contributing factor is that states do not tax nearly as many services as they tax goods. *Id.* at 141. As a result, consumers are changing their behavior by selecting services over goods. *Id.* at 140.

116. See ZODROW, *supra* note 90, at 43.

117. See *id.* at 15.

economic booms but also in the face of changing economic conditions.¹¹⁸ Revenue, therefore, “should grow at approximately the same rate as the state economy, so that periodic rate increases are unnecessary.”¹¹⁹ States, however, often resort to rate increases as opposed to base expansion as a means to meet this demand.¹²⁰ In fact, because political and economic factors have led to significant additional exemptions, the tax base has fallen from 58.7% to 41.9% of personal income since 1979, while the sales tax rate has increased.¹²¹ States increased sales tax rates seventy-two times and lowered them only a few times between 1970 and 2003.¹²² The mean rate was 5.4% in 2008,¹²³ 5.3% in 2004, 4.86% in 1990, and 3.94% in 1980.¹²⁴ In addition, the median rate increased to 5.7% compared to 5.0% in 1990 and 3.25% in 1970.¹²⁵ There was a 49% increase in the mean sales tax rates between 1970 and 2003.¹²⁶ “Yet because of the shrinking sales tax base, this 49 percent increase in sales tax rates produced only a 20 percent gain in sales tax revenues as a share of personal income.”¹²⁷

118. *See id.* at 64.

119. *Id.* at 15. The growth in revenue required under this theory is equal to the inflation rate plus the actual real growth rate of the economy. *Id.*

120. *See Fox, supra* note 5, at 3.

121. *Fox, supra* note 38, at 34; *Fox, supra* note 5, at 3. Professor Fox offers an example of the nationwide pattern. Tennessee’s sales tax revenues rose from 2.0 percent of personal income in 1970 to 3.3 percent in 1996, but the increase resulted entirely from the tax rate doubling, from 3.0 percent to the current 6.0 percent. Without the rate increases, revenues would have fallen to about 1.6 percent of personal income.

Fox, supra note 38, at 34.

122. IRIS J. LAV ET AL., CTR. ON BUDGET & POLICY PRIORITIES, FAULTY FOUNDATIONS: STATE STRUCTURAL BUDGET PROBLEMS AND HOW TO FIX THEM 1, 6 (2005), available at <http://www.cbpp.org/files/5-17-05sfp.pdf>.

123. Federation of Tax Administrators, 2008 State Sales Tax Rates, <http://www.taxadmin.org/fta/rate/sales.html> (last visited Jan. 14, 2010).

124. POMP, *supra* note 11, at 6-2.

125. *Fox, supra* note 38, at 34; Federation of Tax Administrators, 2008 State Sales Tax Rates, *supra* note 123.

126. LAV ET AL., *supra* note 122, at 9-10.

127. *Id.* at 10. According to Professor Mikesell’s research, in 1990 more than 50% of all sales were subject to a sales tax. *Id.* (citing John L. Mikesell, *State Retail Sales Taxes, 1999-2001: The Recession Hits*, STATE TAX TODAY (Feb. 13, 2003)). By 2003 the number of sales subject to sales tax had fallen to 43.3%. *Id.* (citing John L. Mikesell, ‘States of Mind’: *State Retail Sales Tax Burdens, Reliance, and Breadth in Fiscal 2003*, STATE TAX TODAY (July 12, 2004)).

V. THE STRUCTURAL DEFECT OF THE SALES TAX

The biggest issue with the sales tax is that it is outdated and unreliable as a source of revenue for the many state services discussed above.¹²⁸ Part of the problem is cyclical because state revenues decline when the economy experiences decline.¹²⁹ This decline in revenue often leads to service cuts because states are generally required to balance their budgets even in recessionary times.¹³⁰ As indicated above, states often respond to these issues by increasing tax rates to reduce the severity of budget cuts, only to cut taxes later to a level below what is required to maintain services when the economy recovers.¹³¹ This in turn leads to an even bigger crisis when the state economy experiences a downturn in the future.

While this is a significant problem, more critical is the problem of a "structural deficit," which is "the chronic inability of state revenues to grow in tandem with economic growth and the cost of government."¹³² The Center on Budget and Policy Priorities finds that the structural deficit exists because states have failed to modernize their revenue systems to reflect significant changes in the economy over time.¹³³ In fact, several states have failed to change their revenue systems since the 1930s or 1940s, while other states have revenue systems that are outdated by twenty or thirty years.¹³⁴ States gave significant attention to structural deficits in the early 1990s but soon forgot their importance during the economic boom of the mid-1990s.¹³⁵ The economy today, however, is a different story. Failure to modernize revenue systems can lead to substantial problems for the states, such as the problems many are experiencing with the significant economic downturn of 2008 and 2009.¹³⁶ One of the biggest reasons why sales tax revenues have not kept pace with economic growth is the states' failure to tax services.¹³⁷

128. See LAV ET AL., *supra* note 122, at 1.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* A study by the Center on Budget and Policy Priorities, which coined the term, finds that structural deficits reduce public confidence in government. *Id.* at 7. When states increase tax rates simply to maintain the current level of service instead of providing additional services, residents often conclude that the government is being wasteful. *Id.*

133. *Id.* at 1.

134. *Id.*

135. *Id.*

136. See *id.*

137. *Id.* at 9.

VI. CURING THE STRUCTURAL DEFICIT

A. *Services*

States predominately enacted retail sales tax statutes in the 1930s when services were not a large part of the overall economic activity.¹³⁸ States, therefore, introduced the retail sales tax with tangible personal property as its tax base.¹³⁹ For the most part, since the sales tax's inception, the United States economy has shifted from the manufacturing and sale of tangible personal property to an activity-based service economy.¹⁴⁰ In 1965, 32% of the gross domestic product (GDP) came from the production of goods, while services accounted for 30% of the GDP.¹⁴¹ In 2008, however, services expanded to 47% of GDP, while goods declined to 24% of GDP.¹⁴² This shift means that tax systems designed for a tangible goods economy may be "insufficiently robust for the new economic environment."¹⁴³

Despite the shift to a service economy, only a few states impose a sales tax on a broad base of services. Three states—Hawaii, New Mexico, and South Dakota—have adopted general sales tax provisions applicable to most services.¹⁴⁴ According to the Federation of Tax Administrators (FTA), Hawaii taxed 160 out of 168 services the FTA identified in a recent survey, illustrated in Table 2, as having the potential to be taxed by states; New Mexico taxed 158 out of 168; and South Dakota taxed 146

138. FEDERATION OF TAX ADMINISTRATORS, REP. NO. 147, SALES TAXATION OF SERVICES: 1996 UPDATE 1 (1997), <http://www.taxadmin.org/fta/pub/services/rr147.pdf>. During the 1930s, "services averaged only about two-fifths of personal consumption expenditures during that decade." MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, EXPANDING SALES TAXATION OF SERVICES: OPTIONS AND ISSUES 1 (2003), <http://www.cbpp.org/archiveSite/6-19-03sfp.pdf>.

139. Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1, 1 (1988).

140. FEDERATION OF TAX ADMINISTRATORS, SALES TAXATION OF SERVICES: 1996 UPDATE, *supra* at note 138, at 1.

141. See U.S. DEPT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS TABLE 1.1.5: GROSS DOMESTIC PRODUCT (1965), <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&ViewSeries=NO&Java=no&Request3place=N&3place=N&FromView=YES&Freq=Year&FirstYear=1965&LastYear=1965&3Place=N&Update=Update&JavaBox=no#Mid>.

142. See U.S. DEPT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS TABLE 1.1.5: GROSS DOMESTIC PRODUCT (2008), <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&ViewSeries=NO&Java=no&Request3place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2008&LastYear=2008&3Place=N&Update=Update&JavaBox=no#Mid>.

143. Mikesell, *supra* note 34, at 31.

144. Mikesell, *supra* note 22, at 25.

out of 168.¹⁴⁵ “Delaware and Washington tax a large number of services, mainly through their low-rate business gross receipts taxes.”¹⁴⁶ The only other state to tax more than one hundred services is West Virginia.¹⁴⁷ In fact, the majority of states impose the sales tax on less than one-third of the potentially taxable services, while nine states apply their sales tax on less than one-eighth of the services.¹⁴⁸ Other states (Arkansas, Connecticut, Iowa, Kansas, Mississippi, Nebraska, New Jersey, Texas, and Wisconsin) and the District of Columbia tax a large number of services among the categories identified by the FTA in its survey.¹⁴⁹ “These states widely tax utilities, admissions/amusements and labor and repair services, but leave professional services largely untaxed.”¹⁵⁰

Even in the face of economic downturn, many states are taxing the same number of services or less than they taxed in 2005. Of the fifty-one taxing entities, thirty-five still tax services at the same level or below what they did in 2005.¹⁵¹ For example, California taxed twenty-three services on the FTA survey in 2005, yet the state taxed twenty-one services in the 2008 survey, well below the average of fifty-six.¹⁵² What is apparent from this survey is that there is a wide variety of taxing schemes among the states, but few are sufficient to keep pace with the current economy.¹⁵³

B. *Why States Do Not Tax Services*

If state legislators were asked why states predominately tax tangible personal property and not broad-based services, the response would likely be that they have always done it that way. As discussed above,

145. Federation of Tax Administrators, FTA Survey of Services Taxation – Update (July 2008), <http://www.taxadmin.org/fta/pub/services/btn/0708.html#table> (last visited Jan. 14, 2010). The FTA conducted a survey of all fifty states to determine which states tax the 168 services the FTA identified in its survey. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* The FTA identified many categories of services, including the following: utilities; personal services; business services; computer services; admissions and amusements; professional services; and fabrication, repair, and installation. *Id.*

150. *Id.*

151. See Federation of Tax Administrators, *Are You Being Served?: FTA Releases New Data On Taxing Services*, 69 TAX ADM’RS. NEWS 34, 38 (2005), available at http://www.taxadmin.org/fta/pub/services/tan0505_services.pdf; Federation of Tax Administrators, FTA Survey of Services Taxation – Update (July 2008), *supra* note 145.

152. See Federation of Tax Administrators, *supra* note 151, at 38; Federation of Tax Administrators, FTA Survey of Services Taxation – Update (July 2008), *supra* note 145.

153. See LAV ET AL., *supra* note 122, at 1.

when states enacted the sales tax, services were a very small portion of the states' economy.¹⁵⁴ As a result, states largely excluded services from the tax base. There were, and still are, many reasons why states exempt services from the sales tax.¹⁵⁵

Years ago states refused to tax services because many people believed a tax on services was a tax on labor, which made it very unpopular.¹⁵⁶ Economist John Due noted,

The tendency to regard the tax as a levy upon tangible personal property is not the product of careful thought in regard to sound tax structure or administrative feasibility, but of a misconceived attachment of the tax to the articles subject to it rather than to the persons who bear the tax burden.¹⁵⁷

As a consequence, Due advocated for a tax on services, arguing that

a tax on barber service is no more a "tax on labor" than is one on the sale of bread. The burden of the tax must be considered in terms of the persons who bear it, not in terms of the goods and services the sale of which serves as the [tax] base.¹⁵⁸

More recently, commentators cite politics as the best explanation for the states' failure to tax services.¹⁵⁹ Differences in the language and structure of the sales tax between goods and services are the reasons for the success of the political opposition.¹⁶⁰ Tangible personal property sold at retail is normally contained in the sales tax base unless specifically enumerated exemptions apply.¹⁶¹ On the other hand, states only tax services if the specific service is enumerated.¹⁶²

154. See *supra* text accompanying note 138.

155. There were other reasons for including only tangible personal property when states originally adopted sales tax statutes. "First, goods were easy to describe and identify"; people already understood the difference between real property and moveable goods because they were well established in property law. MAZEROV, *supra* note 138, at 1. Second, focusing the sales tax on tangible personal property instead of services "helped to maximize revenues by minimizing the potential for tax evasion" because a paper trail usually existed when goods were sold and resold. *Id.*

156. See MORGAN, *supra* note 1, at 121; Due, *supra* note 22, at 320.

157. Due, *supra* note 22, at 320.

158. *Id.*

159. See POMP, *supra* note 11, at 6-26; Fox, *supra* note 38, at 37.

160. Fox, *supra* note 38, at 37.

161. *Id.*

162. *Id.* Hawaii, New Mexico, and South Dakota are exceptions because those states include broad-based services as part of their sales tax. Federation of Tax Administrators, FTA Survey of Services Taxation – Update (July 2008), *supra* note 145. For example, South Dakota's sales tax statute reads as follows:

Iowa's sales tax statute is representative of this point. It provides as follows: "There is imposed a tax of six percent upon the sales price of all sales of tangible personal property, consisting of goods, wares, or merchandise, sold at retail in the state to consumers or users except as otherwise provided in this subchapter."¹⁶³ Iowa's statute specifically enumerates over one hundred services the state taxes:

The sales price of any of the following enumerated services is subject to the [sales] tax . . . : alteration and garment repair; armored car; vehicle repair; battery, tire, and allied; investment counseling; service charges of all financial institutions; barber and beauty; boat repair; vehicle wash and wax; campgrounds; carpentry; roof, shingle, and glass repair; dance schools and dance studios; dating services; dry cleaning, pressing, dyeing, and laundering; electrical and electronic repair and installation; excavating and grading; farm implement repair of all kinds; flying service; furniture, rug, carpet, and upholstery repair and cleaning; fur storage and repair; golf and country clubs and all commercial recreation; gun and camera repair; house and building moving; household appliance, television, and radio repair; janitorial and building maintenance or cleaning; jewelry and watch repair; lawn care, landscaping, and tree trimming and removal; [and] limousine service¹⁶⁴

This structure puts state lawmakers in the unpopular position of selecting specific services and industries on which to impose the sales tax.¹⁶⁵ These industries become galvanized against a change in the sales tax base and are often willing to expend considerable resources to defeat the legislation and perhaps the legislator in a reelection.¹⁶⁶ Base broadening to include services, therefore, is often discussed among politicians, but a plan is seldom fortified.

Of course, failing to tax services because tangible personal property has always been taxed or because it is politically difficult does nothing to close the gap between needed revenue and actual revenue.¹⁶⁷ In

There is hereby imposed a tax at the same rate as that imposed upon sales of tangible personal property in this state upon the gross receipts of any person from the engaging or continuing in the practice of any business in which a service is rendered. Any service as defined by § 10-45-4.1 shall be taxable, unless the service is specifically exempt from the provisions of this chapter.

S.D. CODIFIED LAWS § 10-45-4 (1996).

163. IOWA CODE ANN. § 423.2 (West 2008).

164. *Id.*

165. Fox, *supra* note 38, at 37–38.

166. *Id.* at 38.

167. See generally LAV ET AL., *supra* note 122, at 6 (illustrating Maryland's gap between operating expenses and ongoing revenues).

fact, economists generally agree on the idea to tax the treatment of services, believing that “all services sold to consumers should be fully taxed, while all services sold to businesses should be excluded from the sales tax base.”¹⁶⁸ Economist John Due best states the rationale:

[T]here is no basic reason why sales taxes should be confined to commodities; the tendency to do so . . . is more the product of historical accident than logic. The objective of a sales tax is to distribute the costs of governmental services in relation to consumer spending, with the usual and reasonable assumption that the taxes are shifted forward by the firms from which the tax is collected to the consumers of the products. Acquisition of service by households constitutes consumption expenditure in the same fashion as the purchase of commodities; there is no basic difference between the two that warrants different tax treatment.¹⁶⁹

Due goes on to rationalize the tax on services:

From an economic standpoint, the distinction between a service and a commodity is not a very significant one, since both satisfy personal wants [T]he failure to include services rendered to consumers gives rise to the same objectionable results as the exemption of specific commodities. Persons making relatively high expenditures for services are favored compared to those concentrating their purchases on tangible goods, resource allocation may be distorted, and in some cases administrative complications are created.¹⁷⁰

Other commentators note that “[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.”¹⁷¹

C. *Benefits of Taxing Services*

A majority of states could benefit from including services in the sales tax base for many reasons. First, taxing services can produce substantial new sales tax revenue. In today’s economy, most states are in financial distress.¹⁷² A recent study by the Center on Budget and Policy Priorities found that states could raise \$57 billion “from taxing all

168. Michele E. Hendrix & George R. Zodrow, *Sales Taxation of Services: An Economic Perspective*, 30 FLA. ST. U. L. REV. 411, 414 (2003).

169. John F. Due, *Proposed Application of the Illinois Sales Tax to Services*, 44 ILL. BUS. REV. 3, 3 (1987).

170. JOHN F. DUE, SALES TAXATION 374 (1957).

171. Hendrix & Zodrow, *supra* note 168, at 415.

172. MAZEROV, *supra* note 138, at v.

services purchased by households except health care, education, housing, and a few others.¹⁷³ Most states already tax some services; therefore, this \$57 billion would not be entirely new revenue.¹⁷⁴ Nevertheless, the study indicates that services could “generate sales tax revenue equal to 25–35 percent of current sales tax collections in about three-fourths of the 45 states currently levying a sales tax.”¹⁷⁵ For states like California, which taxes relatively few services, more than \$8 billion could be realized.¹⁷⁶

Second, including services in the sales tax base could stabilize revenue. Economists believe consumption as a tax base is more stable over time than income.¹⁷⁷ This theory is based on the fact that the sales tax is “dominated by purchases of ‘big-ticket’ durable goods such as cars, appliances, and furniture; such purchases often decline sharply during economic downturns.”¹⁷⁸ In addition, taxing 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.”¹⁷⁹ Consequently, a broad consumption tax base including services is likely to enhance revenue stability.¹⁸⁰

Third, the other revenue stability argument this Article previously discussed involves a more long-term problem. Consumption of services is increasing while consumption of goods is decreasing.¹⁸¹ Without taxing those services, this necessarily results in a declining tax base.¹⁸² This trend is likely to continue for a few reasons. First, for several types of services, “there are inherent limits on the ability of technology to

173. *Id.*

174. *Id.* at 4.

175. *Id.*

176. *Id.* “The annual revenue yield in specific states ranges from more than \$8 billion in California to just \$77 million in Wyoming.” *Id.* States that tax few services—California, Colorado, Illinois, Massachusetts, Montana, Nevada, and Virginia—could gain substantial revenue. *Id.* Some states have conducted their own studies on taxing services. *Id.* at vii. Texas estimated that increasing its tax base by taxing five services would yield an additional \$600 million annually. *Id.* Michigan, on the other hand, estimated it could raise an additional \$4.8 billion annually. *Id.*

177. Hendrix & Zodrow, *supra* note 168, at 418.

178. LAV ET AL., *supra* note 122, at 10; *see also* MAZEROV, *supra* note 138, at 12.

179. Hendrix & Zodrow, *supra* note 168, at 418.

180. *Id.* An empirical study by Richard Dye and Therese McGuire confirms this result, as their findings “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.” *Id.* (citing 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)).

181. *See supra* text accompanying notes 140–42.

182. *Id.*

increase productivity and reduce costs.¹⁸³ Personal trainers, nurses, and nursing home workers can only care for a certain number of people in a given day; "an actor can put on only so many performances."¹⁸⁴ Manufacturing, however, is still subject to productivity improvements.¹⁸⁵ Therefore, "[i]f the price of goods is held down by further gains in manufacturing productivity, the share of total household spending devoted to goods is likely to fall even if the actual quantity of goods purchased holds steady."¹⁸⁶ Second, as the baby boom population ages, spending on health care will likely increase.¹⁸⁷ Finally, as Americans become wealthier in general, the desire for services such as spas, lawn service, housekeepers, health clubs, and sporting events increases.¹⁸⁸

Fourth, including services in the sales tax base would increase horizontal equity, making the sales tax fairer. The sales tax in states that tax few services discriminates against those consumers with a preference for taxed consumer goods, while favoring those with a preference for untaxed services.¹⁸⁹ Moreover, higher income groups consume more untaxed services than lower income groups, which means that the sales tax in its current structure in most states disproportionately favors wealthier consumers.¹⁹⁰ Yet, both untaxed services and taxed goods equally satisfy particular needs and consume equal amounts of society's resources.¹⁹¹ Taxing services would improve horizontal equity.¹⁹²

Finally, including services in the sales tax base could improve and simplify administration.

A tax policy that causes problems for taxpayers or difficulties for the state tax agency is a tax policy that will fail. If taxpayers do not believe that taxes are understandable, they will not think them fair. If the tax agency cannot audit to ensure accurate compliance, then voluntary compliance will vanish. If the costs of compliance are excessive, taxpayers will not comply. Tax law that relies on arbitrary or illogical distinctions forces extensive, time consuming and costly litigation. Administration and compliance go hand in hand. A tax that

183. MAZEROV, *supra* note 138, at 11.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. Hendrix & Zodrow, *supra* note 168, at 419.

190. *Id.*

191. MAZEROV, *supra* note 138, at 13.

192. *Id.*

cannot be administered [by tax officials] is a tax that has poor compliance [on the part of taxpayers].¹⁹³

Taxing goods and exempting services leads to problems in several areas. First, retailers must distinguish taxable goods from exempt services when retailers sell both.¹⁹⁴ "The fewer services that are exempt, the less the administrative problems of policing the tax, because difficult line drawing problems between taxable goods and exempt services, or between taxable and exempt services, are less likely to arise."¹⁹⁵ Second, if vendors sell both taxable goods and exempt services, the vendor may "allocate the aggregate price of a transaction in a manner that minimizes the tax."¹⁹⁶ For instance, "an interior decorator may increase his or her exempt fee rather than marking up the price of taxable furniture."¹⁹⁷ If states taxed both goods and services, complications would be less likely to arise.

VII. CONCLUSION

The majority of states enacted a sales tax between the 1930s and 1950s. During that period, goods dominated the economy. States intended the sales tax to tax people on their consumption of these goods. To maximize revenue, therefore, states established tangible personal property as the tax base for the sales tax. Over the last thirty years, however, the economy has transitioned to services. State tax structures have not kept pace with this change in the economy. Consequently, in many states there is gap between needed revenue and actual revenue. To cure the structural deficit in states' taxing structures, states should increase the tax base to include services. "Given that the sales tax is intended to tax people on their consumption of resources, there is no reason why the individual who purchases services should not also pay tax on that consumption."¹⁹⁸

193. *Id.* at 20 (citation omitted).

194. *Id.*

195. POMP, *supra* note 11, at 6-30.

196. *Id.*

197. *Id.*

198. MAZEROV, *supra* note 138, at 13.
