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Why States Should Consider Expanding Sales Taxes to Services, Part 1

Gladriel Shobe
BYU Law, shobeg@law.byu.edu

Grace Stephenson Nielsen

Darien Shanske
University of California, Davis, dshanske@ucdavis.edu

David Gamage
Indiana University Maurer School of Law, dgamage@indiana.edu

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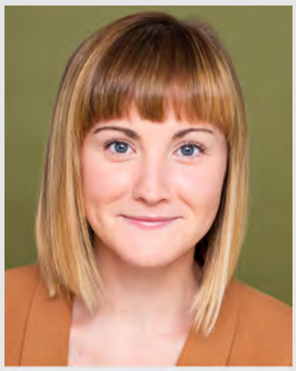

Grace Stephenson Nielsen

Darien Shanske

David Gamage

Gladriel Shobe is an associate professor and Grace Stephenson Nielsen is a student at Brigham Young University Law School. Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall) and David Gamage is a professor of law at Indiana University Maurer School of Law.

In this installment of Academic Perspectives on SALT, the authors explore the general case for why states should consider expanding their sales tax bases to more services as a response to the fiscal challenges of the COVID-19 crisis.

States are facing a severe budget crisis as a result of the coronavirus pandemic. And with the federal government unlikely to pass a relief bill to address those state budget issues,[1] states will need to play a significant role in making up revenue shortfalls.

This is the first in a three-part series, which is a contribution to Project SAFE: State Action in Fiscal Emergencies. This essay will lay out the general case for why states should consider expanding their sales tax bases to more services as a response to the COVID-19 crisis. The follow-ups will discuss further mechanics and details of how best to accomplish this goal. In particular, the second essay will argue that there are low-hanging reforms that could raise substantial revenue, would represent good tax policy, and might be politically possible even during the current crisis. In the third essay we will then introduce reforms to help with the critical problem of tax pyramiding.

The COVID-19 State Budget Crisis

States depend primarily on income and sales tax revenue to fund services, including education and healthcare. COVID-19 has decimated these revenue sources. Income tax revenue plunged because of the rise in unemployment, and the sharp decline in retail sales was due to social distancing restrictions that prevent most retailers from operating at

1 Alexis Gravely, "Smaller COVID-19 Relief More Likely as Dems Underperform in Election," *Tax Notes Federal*, Nov. 9, 2020, p. 982.

full capacity.[2] Although it is impossible to predict the full effect of COVID-19 on state budgets, estimates indicate that states and localities will face shortfalls between $450 billion and $650 billion over the next two years, with the higher end of those estimates being reached if a surge in COVID-19 cases causes a "double-dip" recession.[3] These estimates are somewhat smaller than forecasters projected during the height of the pandemic, but still represent massive shortfalls, especially in light of the expiration of federal aid programs and rising pandemic-related state expenses.[4]

Because states generally operate under balanced budget requirements, they either need to bring in more money or cut costs during a recession.[5] The federal government, which has more flexibility than states to borrow money and raise revenue, provided $150 billion to the states through the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) in March. However, that amount fell far short of filling the state budget gaps.[6] Since March, Congress has considered several bills to provide additional funding to states, but the House and Senate have been at a political impasse thanks to contrasting views as to what a relief package should include.[7] Given the recent elections and continued division in Congress, new federal aid will almost certainly fail to make up for state budget shortfalls even if additional relief is approved.[8]

It therefore seems inevitable that over the next few years, states will need to play a significant role in closing their budget gaps by raising taxes, cutting expenses, or some combination of the two. During a recession, states primarily balance their budgets by reducing spending rather than raising taxes, as evidenced by the extensive state budget cuts to education, health, and social services during the Great Recession.[9] Unfortunately, these cuts tend to slow economic recovery and shrink states' safety net for vulnerable residents when state services are needed most.[10]

Despite the harmful ramifications of budget cuts during a recession, states have responded to the current recession by reducing spending — including for essential state services, and they will have to make deeper spending cuts over the next few years unless they raise additional revenue.[11] For example, Medicaid, which is funded by a mix of state and federal dollars, represents an important share of state

[2] *See* Michael Leachman and Elizabeth McNichol, "Pandemic's Impact on State Revenues Less Than Earlier Expected but Still Severe," Center on Budget and Policy Priorities (Oct. 30, 2020) (showing estimates by Moody's Analytics of shortfalls totaling $450 billion to $650 billion and explaining their own estimates of shortfalls totaling $480 billion to $620 billion); Kate Davidson and David Harrison, "Coronavirus-Hit State Budgets Create a Drag on U.S. Recovery," *The Wall Street Journal*, Aug. 12, 2020; and Nelson D. Schwartz and Gillian Friedman, "Unemployment Claims Rise Anew in Latest Sign of Economic Distress," *The New York Times*, Oct. 15, 2020.

[3] Leachman and McNichol, *supra* note 2. *See also* Neil Irwin, "The Pandemic Depression Is Over. The Pandemic Recession Has Just Begun," *The New York Times*, Oct. 3, 2020; and Louise Sheiner and Sophia Campbell, "How Much Is COVID-19 Hurting State and Local Revenues?" Brookings Institution (Sept. 24, 2020).

[4] Tracy Gordon, "Improving State Tax Collections Don't Let Congress Off the Hook on COVID-19 Relief," Tax Policy Center (Nov. 19, 2020).

[5] Because states generally operate under balanced budget requirements, borrowing against future revenue is restricted as a mechanism for managing shortfalls in states' general budgets. *See* David Gamage, "Preventing State Budget Crises: Managing the Fiscal Volatility Problem," 98 *Cal. L. Rev.* 749, 754-68 (2010) (discussing the fiscal volatility problem and the nature and implications of state balanced budget constraints).

[6] *See* Leachman and McNichol, *supra* note 2; Leachman, "To Support Education, Congress Should Provide Substantial Fiscal Relief to States and Localities," CBPP (Jun. 15, 2020) ("The federal aid provided so far can close roughly $100 billion of those gaps, leaving states $515 billion short."); and Congressional Budget Office, Letter of Director Phillip L. Swagel to John Yarmuth, Chairman, House Committee on the Budget Regarding Answers to Questions Related to Federal Funding for State and Local Governments (May 13, 2020).

[7] One of the most contentious issues is how much additional funding, if any, the federal government should provide to states and localities. *See* Kristina Peterson and Andrew Duehren, "Coronavirus Stimulus Talks With White House at Impasse," *The Wall Street Journal*, Oct. 11, 2020; and Duehren and Davidson, "State-Aid Disagreement Proves Big Hurdle for Coronavirus Talks," *The Wall Street Journal*, Aug. 14, 2020.

[8] *See* Gravely, *supra* note 1.

[9] During the Great Recession, 40 states implemented tax or fee increases, though those tax increases were relatively small compared with state budget cuts. *See* Gordon, "State and Local Budgets and the Great Recession," Brookings Institution (2012) ("Despite its severity, states relied less on revenue increases as a solution in the recent downturn. Although tax and fee increases in fiscal year 2009-2010 were the highest on record ($23.9 billion), this was in nominal terms and not as a percentage of prior year collections.").

[10] *See id.*; and David Cooper, "Without Federal Aid, Many State and Local Governments Could Make the Same Budget Cuts That Hampered the Last Economic Recovery," Economic Policy Institute: Working Economics Blog (May 27, 2020); *see generally* Nicholas Johnson, Phil Oliff, and Erica Williams, "An Update on State Budget Cuts," CBPP (Feb. 9, 2011).

[11] Although a handful of states have proposed or enacted tax increases since the start of the pandemic, states have primarily closed their budget shortfalls through budget cuts. *See* National Conference of State Legislatures, "State Actions to Close Budget Shortfalls in Response to COVID-19." *See also* David Harrison, "State, Local Governments Slashed Spending After COVID. Next Year Could Be Worse," *The Wall Street Journal*, Nov. 29, 2020.

spending[12] and enrollments tend to rise during an economic downturn. But with revenue streams now pinched, many states have enacted or proposed bills to cut state Medicaid funding despite a projected rise in enrollments through 2021.[13] The same is true for education: Since the start of the pandemic, approximately half of states have cut education funding despite the increase in COVID-19-related costs borne by schools (for example, personal protective equipment, facility cleaning, virus testing, and distance learning costs).[14] This is troubling because remote and hybrid learning is particularly difficult for vulnerable populations, yet education funding cuts tend to disproportionately affect poorer school districts.[15]

To limit the harmful consequences of cuts to education, healthcare, and other important programs, states should rely more heavily on tax increases during this recession than they have in the past.[16] Some options include raising income taxes on the wealthy, modifying statutory balanced-budget rules, decoupling from the federal base, imposing new state-level taxes, and expanding the state sales tax bases.[17] This series will focus on just one of those options: broadening the state sales tax base to services.[18] We do not believe that states should rely on expanding the sales tax alone; rather, we think that this sensible reform should be part of the revenue mix that the states use to counter the crisis. In particular, given how the crisis has disproportionately hurt the already vulnerable, taxing on the basis of ability to pay or wealth seems appropriate.

Further, states should — and in many cases could — borrow, and therefore we do not believe that revenue increases need to make up for the entire shortfall.[19] If the states make wise base-broadening reforms, then they should be able to borrow the funds they need to avert the most destructive cuts.

Why States Should Tax Services

There are several arguments to support the expansion of state sales tax bases to services. In 2020 the most pressing reason is that taxing services would significantly increase revenue in most states.[20] For example, when Utah attempted to expand its retail sales tax base to all services by default in 2019, state auditors estimated the legislation would bring in an additional $230 million in 2020.[21] In 2017 Illinois estimated that it could raise close to $3 billion more per year if it taxed the same services that

[12] Medicaid and CHIP Payment and Access Commission, Medicaid's Share of State Budgets.

[13] *See* NCSL, *supra* note 11; and Robin Rudowitz et al., "Medicaid Enrollment & Spending Growth: FY 2020 & 2021," Kaiser Family Foundation (Oct. 14, 2020).

[14] *See* NCSL, *supra* note 11; and Michael DiNapoli Jr., "Making School Budgets Whole and Equitable During and After COVID-19," Learning Policy Institute (July 17, 2020).

[15] *See, e.g.*, Emily Oster, "Schools Aren't Super-Spreaders," *The Atlantic*, Oct. 9, 2020; Julien Lafortune, Radhika Mehlotra, and Jennifer Paluch, "Funding California Schools When Budgets Fall Short," Public Policy Institute of California (Oct. 2020); and Johnson, "As School Year Starts, Schools Face New and Lingering Challenges," CBPP (Aug. 24, 2020).

[16] Wesley Tharpe, "For Tax Day 2020, 6 Charts on State Taxes and Spending," CBPP (Jul. 13, 2020) ("To reduce the need for harmful cuts in [education and healthcare], states should quickly look to raise additional revenues. Policymakers should focus on equitable ways to do so.").

[17] For a compilation of various ways that states could raise revenue, see the Project SAFE website, which is the collaboration of several law professors. *See also* Naomi Jagoda, "Arizona Voters Approve Ballot Measure to Raise Taxes on High-Income Households," *The Hill*, Nov. 5, 2020; and Samantha Waxman, "States Should Tax Wealth to Respond to COVID-19," CBPP (Sept. 23, 2020).

[18] To be clear, the point of this article is not to argue that this is necessarily the best way to close state budget gaps, and there are good arguments in favor of the alternatives. However, state-level political and statutory constraints essentially eliminate some of these options in many states (e.g., many states have statutory limitations on progressive income taxes).

[19] Gamage and Darien Shanske, "The Case for State Borrowing as a Response to the Current Crises," *Tax Notes State*, Sept. 14, 2020, p. 1137.

[20] The state revenue projections in this section are descriptive — reflecting estimates for proposed or enacted state tax packages — rather than normative and prescriptive. They may therefore include tax revenue from items that policymakers and scholars generally agree should not be in the base. This is especially problematic for business inputs, which comprise around 40 percent of most states' tax bases (*see* Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 12.03 (3d. ed. July 2020)), so this concern will be treated in depth in the second and third essays in this series.

[21] Fiscal Note, H.B. 441, 63d Leg., Gen. Sess. (Utah 2019) (bill not passed).

are taxable in Iowa, which taxes a relatively broad range of services.[22] And North Carolina, which added several services to its tax base in 2016, estimated that the change raised at least $84.8 million more in sales tax revenue in the first year.[23]

Since each state includes a different mix of transactions in its sales tax base, economists and policymakers have found it difficult to make concrete projections about how much revenue a broad services tax would raise if all states were to add consumer services to their tax bases. At least one estimate, though, places the potential "annual, nationwide revenue yield from taxing all services purchased by households" in the tens of billions.[24]

COVID-19-related budget shortfalls could provide the political impetus for expanding states' sales tax bases, much as collapsing revenues during the Great Depression led to states adopting general retail sales taxes in the first place.[25] But beyond the revenue potential, taxing services makes substantive policy sense, too.

First, expanding the base would help modernize state sales taxes.[26] When states first enacted sales taxes, the purpose was to capture consumer spending.[27] Because at that time consumers spent much more on goods than services, states were able to tax most consumer spending by taxing the sale of goods but excluding all but a few services.[28] Since the mid-20th century, consumer spending has shifted toward services and away from goods.[29] Sales of goods may have been a workable — albeit imperfect — sales tax base in 1950, when services only accounted for 39 percent of personal consumption.[30] Today, however, services account for 69 percent of consumer spending[31] — meaning that most state sales taxes are based on the economy as it existed nearly a century ago.

It is further worth noting on this point that the U.S. tax system as whole, considering both the state and federal levels, dramatically undertaxed spending as compared with every other developed nation.[32] This is because every other developed nation raises a large portion of its overall revenue from a value added tax.[33] By contrast, the United States levies neither a value added tax nor any substantial tax on spending, and U.S. state sales taxes are much smaller in both scope and magnitude as compared with other nations' VATs.[34]

Second, a tax on services could help eliminate the current arbitrary distinctions between closely related consumer goods and services, which may distort consumer choices by artificially making

[22] *See* Illinois General Assembly, Commission on Government Forecasting & Accountability, at 11 (Jan. 2017). Many other states have provided similar revenue estimates. For example, Connecticut, which already added some services to its sales tax base in 2012, could raise an additional $730 million to $1.5 billion by expanding its sales tax to even more services. *See* Derek Thomas, "Revenue Options Are Key to Addressing Budget Shortfalls and Supporting Thriving Communities," Connecticut Voices for Children (Jan. 2017).

[23] *See* H.B. 1030: Senate Finance Provisions in the 2016 Appropriations Act (Jun. 7, 2016); BGW CPA, "N.C. Adds Sales Tax to Services" (Mar. 1, 2016); *see also* Jared Walczak, "Enhancing Tax Competitiveness in Connecticut," Tax Foundation (Jul. 31, 2018).

[24] *See* Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," *State Tax Notes*, Aug. 24, 2009, p. 517, at iii (estimating $87 billion and granting exemptions for specific household essentials); and Federation of Tax Administrators, "FTA Survey of Services Taxation — Update," By the Numbers (July-Aug. 2017), at 1 (noting that although many states tax services like hotels, event admissions, utilities, and repairs, only a small minority of states tax the personal and professional services that comprise most service transactions).

[25] *See* Kirk J. Stark, "The Uneasy Case for Extending the Sales Tax to Services," 30 *Fla. St. U.L. Rev.* 435, 440 (2003).

[26] *E.g.*, Leachman, "Four Ways to Modernize State Sales Taxes," CBPP (July 9, 2013). The recent U.S. Supreme Court decision in *South Dakota v. Wayfair Inc.*, 138 S.Ct. 2080 (2018), allows states to require businesses to collect and remit state sales tax on internet purchases. *Wayfair* helped bring state sales tax regimes into the 21st century, but it represents just one piece of the modernization puzzle.

[27] *See* Stark, *supra* note 25, at 440-41.

[28] Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" 4 *New Eng. Econ. Rev.* 27, 31 (2001) (describing administrability concerns for taxing service transactions "undertaken primarily by very small firms with minimal record-keeping capacity"); and Hellerstein, Hellerstein, and Swain, *supra* note 20, at para. 12.05) ("When state legislatures first enacted general sales taxes during the 1930s, they confined the tax base largely to sales of tangible personal property, with taxation of services limited to utility services and admission fees.").

[29] Jonathan D. Church, "Explaining the 30-Year Shift in Consumer Expenditures From Commodities to Services, 1982-2012" Bureau of Labor Statistics (Apr. 2014) (analyzing consumer spending showing that since around 1990, Americans have spent "more money on services than on commodities").

[30] Bureau of Econ. Analysis, U.S. Dep't of Com., National Income and Product Accounts Tables, tbl.1.1.5.

[31] *Id.*

[32] *See, e.g.*, Ajay K. Mehrotra, "The Myth of the 'Overtaxed' American and the VAT That Never Was," *Modern American History* (Mar. 2019), at 97-98; Andrea Louise Campbell, "America the Undertaxed," *Foreign Affairs* (Sept.-Oct. 2012), at 99-100.

[33] Mehrotra, *supra* note 32; Campbell, *supra* note 32.

[34] Campbell, *supra* note 32.

service transactions less expensive.[35] For example, if purchasing a lawn mower with a useful life of four years and hiring a lawn care service over that same period each cost $400 before sales tax, and only the lawn mower purchase is taxable, the fact that the latter is taxed makes it more expensive relative to the cost of the lawn care service.

A general maxim of tax policy is that broad-based taxes are superior at minimizing economic distortions. Expanding state sales taxes to services would broaden their base and enhance their efficiency. Indeed, the arbitrary sales tax distinction between goods and services in a sense results in higher taxes on goods because the items that remain in the tax base must bear the full brunt of the sales tax revenue burden.[36] Adding services to their sales tax bases allows states to lower their overall average sales tax rates (perhaps after state finances recover from the pandemic), which would reduce the price of goods and services already subject to tax without decreasing overall sales tax revenue.[37]

Of course, all consumption taxes raise significant design concerns. First, business inputs should generally remain untaxed.[38] When business inputs are taxed, businesses raise retail prices to cover sales taxes paid on transactions during production, a concept often referred to as tax pyramiding (that is, a tax on a tax).[39] This is especially problematic in the sales tax context in which there may be many levels involved in production processes. To address this issue, the third essay in this series will evaluate options for credits, deductions, or exclusions for business-to-business purchases, so that services can be incorporated into the sales tax base without exacerbating tax pyramiding concerns.

Another concern is that sales taxes (like other consumption taxes) are generally regressive because they are imposed at a flat rate, and lower-income taxpayers spend a greater portion of their income on goods and services.[40] But this concern is likely to be more than offset by the progressivity of how revenues are spent. Because most major categories of state spending benefit low-income populations, the overall result of funding incremental spending or preventing cuts through an expanded sales tax base is, in fact, progressive.[41]

Conclusion

Overall, the benefits of taxing consumer services — for both policy and revenue reasons — are important enough that through thoughtful design, state legislatures can largely avoid the problems that taxing services might otherwise raise. Especially in this time of severe revenue needs, the modernization of state sales taxes via broader bases is overdue. In the two planned follow-ups in this series, we will explain how best to accomplish this. ■

[35] Alan R. Romero, "Including Legal Services in State Sales Taxes," 29 *Harv. J. Leg.* 280, 286; and Stark, *supra* note 25, at 448.

[36] For example, Illinois ranks 43rd in the United States for the breadth of its sales tax base, but 13th for its sales tax rate. Chicago Metropolitan Agency for Planning, "The Benefits of Adding More Services to Illinois' Sales Tax Base," at 3 (Mar. 5, 2019).

[37] Hellerstein, Hellerstein, and Swain, *supra* note 20, at para. 12.05.

[38] For example, most countries that use a VAT also follow the "credit-invoice method" to make intermediate business transactions taxable but creditable. Tax Policy Center, "Briefing Book: How Would a VAT Be Collected?" (last updated May 2020). This means "there are no net taxes on sales between registered VAT businesses," and only "the full value of the final sale to the consumer bears tax." *Id.*

[39] *See, e.g.*, Michele E. Hendrix and George R. Zodrow, "Sales Taxation of Services: An Economic Perspective," 30 *Fla. St. U.L. Rev.* 411, 416 (2003); Mazerov, *supra* note 24 ("pyramiding"); and Shanske, "Expanding State Fiscal Capacity, Part I: A New and Improved Consumption Tax Paired With a Tax on a Federal Windfall (the QBI Deduction)," *Fla. Tax Rev.* (forthcoming 2020) (manuscript at 14-15).

[40] *See, e.g.*, Elaine S. Povich, "Why States Are Struggling to Tax Services," *Stateline* (June 27, 2017).

[41] *See* Gladriel Shobe, "Disaggregating the State and Local Tax Deduction," 35 *Va. Tax Rev.* 327, 334 (2016).