

Taxing Services*

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From the standpoint of economic theory, taxes are judged by the sometimes conflicting standards of efficiency and equity. Efficient taxes place as small a burden on taxpayers as possible over and above the revenues they extract, and are neutral in the sense that they do not cause taxpayers to make different economic choices than they would make in the absence of taxes. No tax meets the ideal of efficiency completely, because taxes always impose some burden on taxpayers beyond the revenues they collect, and all taxes discourage the taxed activity, so alter people's economic choices. One goal of tax policy is to reduce inefficiencies in the tax system. Equity is a more subjective goal of tax policy, but with respect to applying Florida's sales tax to services, one way to view it is that it would be equitable for goods and services to be treated the same way by the sales tax.¹ An ideal sales tax would tax all retail sales once but only once to preserve neutrality, and neutrality would also require that the tax system treat the purchase of services in the same manner as the purchase of goods.

Taxes are necessary to finance government, and the goal of neutrality is to design a tax system that distorts the economic decisions people make as little as possible to preserve the market allocation of resources.² A sales tax that taxes all retail purchases once but only once, at the same rate, discourages retail purchases but does not give a differential incentive to make one purchase over another. If some purchases are untaxed, or if some are taxed more heavily than others, then the sales tax will have a distorting effect on economic activity.³ Florida's sales tax misses the ideal of neutrality by a substantial amount. Florida does not tax many retail purchases, but taxes many non-retail purchases.⁴ Services are treated differently from goods in Florida's sales tax, because the tax was originally designed as a tax on the retail sale of tangible goods, excluding services from taxation altogether. The legislature has changed the sales tax law to some degree in almost every legislative session since the tax was first implemented in 1949,⁵ but the original structure of the sales tax

remains. This article provides a brief explanation of the way services are treated by Florida's sales tax, why they are treated that way, and how, ideally, they should be treated.

Background

Florida's sales tax was originally designed to be a tax on the retail sale of tangible goods, and the basic orientation of the sales tax remains that way. Florida Statutes, Title XIV, Chapter 212.05, states that it is "... the legislative intent that every person is exercising a taxable privilege who engages in the business of selling tangible personal property at retail in this state," which describes the original orientation of the law. Originally, many goods were exempt from the tax, including automobiles, most clothing, and groceries.⁶ A transaction is exempt if it would be taxed under the law were it not for a specific provision that makes it non-taxable. For example, automobiles are tangible personal property, but the original law included wording to exempt them. There was no exemption for services because they are not tangible goods, so were excluded from the sales tax. The terminology is relevant, because in the discussion of the services tax, exemptions and exclusions are often lumped together and referred to as exemptions. Yet services are not exempt from the sales tax; they are excluded. Some services are taxed because specific wording was added to the statutes to tax them, but most services are excluded – not exempt – because they are not tangible goods.⁷

Historically, services have been excluded from Florida's sales tax, but there is no compelling reason for the sales of services to be treated differently from the sale of goods. There is, however, a good reason for exempting non-retail sales from the sales tax, because the taxation of non-retail sales results in double taxation, or tax pyramiding. This has been a key issue in the services tax debate in Florida, so it is worth close examination.

Tax Pyramiding

Tax pyramiding occurs when a transaction is taxed multiple times, as would happen if an intermediate good or service were taxed and then the final retail transaction that the intermediate good or service helped produce was also taxed. Business equipment is sales taxable, for example, so

when a business buys a computer, it pays sales tax. This purchase is a cost of doing business which must be covered in the price of the final output the business sells, so the business's computer purchases are taxed twice: once when the business buys the computer, and then again when the cost of the computer – including the tax – is incorporated into the price of the final sale. About one-third of Florida's sales tax base is made up of non-retail transactions, so Florida's sales tax already contains a considerable degree of tax pyramiding.

Tax pyramiding is a major issue in the taxation of services because most services that would be covered under the typical services tax proposal are not retail services. Advertising, legal services, accounting services, and consulting services are all examples of services that are purchased primarily by businesses, and their cost must be passed on in the final price of the businesses' sales. Consider an example of an architect, whose services are currently untaxed, who contracts with an engineering firm, whose services are currently untaxed, to help on a project. The engineer then hires a draftsman as an independent contractor, whose services are currently untaxed, to help with the engineer's work on the project. Now assume that a 6 percent sales tax is extended to the purchases of all services. The engineer must pay 6 percent sales tax on the draftsman's services, which then become a part of the engineer's costs. When the architect pays for the engineer's work, included in that cost is the draftsman's contribution, on which another 6 percent sales tax is paid, for a total of 12 percent. The draftsman's work is also included in the final price the architect charges, so the draftsman's work is now taxed again, along with the engineer's work, so 18 percent sales tax is paid on the draftsman's work, and 12 percent is paid on the engineer's work, along with the 6 percent for the services performed by the architect. This tax pyramiding occurs because the taxed transactions are non-retail transactions, not because they are services.

Most of the revenues that would be raised under recent service tax proposals would be from non-retail services, so would lead to tax pyramiding. The 1987 services tax promoted by Governor Martinez contained substantial tax pyramiding because it would have taxed legal services, accounting services, consulting services, and advertising, all of which are sold primarily to businesses, not to retail purchasers. Advertisers were strong opponents of that tax, and while it was in their self-interest

to oppose it, they were also opposing tax pyramiding. When a firm buys advertising, it is a cost of doing business that must be recaptured in the final sales price, and if the advertising is taxed when it is originally sold, it is taxed again when sales tax is paid on the price of the final product. The tax reform plan promoted by Senate President John McKay in 2002 also contained a substantial amount of tax pyramiding. In McKay's plan, more than 60 percent of new revenues would have been generated by taxes on business and professional services, and less than 6 percent would have been from taxes on currently-untaxed personal services.⁸

One problem with tax pyramiding is that it gives purchasers an incentive to bring taxed functions in-house rather than pay the tax. For example, companies can hire their own attorneys rather than paying 6 percent sales tax to hire an outside firm, and companies can establish their own in-house advertising and accounting departments rather than purchase those services on the market. In the example above, if the architect hired his own engineers and draftsmen as employees rather than contracting for those services with outside firms, no services tax would be due. This is a problem because businesses then make their decisions based on how to avoid taxes, rather than on what is the most efficient way to do business, so the tax is not neutral. Furthermore, large firms will have a greater ability to bring such functions in-house than small firms that may not have enough business to hire full-time accountants or attorneys, so tax pyramiding favors large businesses over small businesses, again violating the principle of neutrality. A tax on business services would also drive much of this type of business out-of-state, to states that do not tax services, causing a more direct harm to Florida's economy.⁹

There is a good argument for taxing retail services, but the tax pyramiding created by taxing non-retail services would tax those services more heavily than retail transactions, resulting in inefficiency. Proponents of extending Florida's sales tax to services argue that the sales tax should treat goods and services the same, so such services as haircuts, lawn care, and swimming pool maintenance services should be taxed the same way as combs, lawn mowers, and swimming pool supplies. These examples misrepresent the type of taxation that would take place under a comprehensive

services tax. The bulk of the new revenues that would be raised under recent service tax proposals would come not from taxing retail services, but from taxing business services.

The Service Economy

One argument often heard in support of extending Florida's sales tax to services is that the economy is shifting toward the production of services over goods, so a goods-based sales tax will not keep up with the state's economic growth. In fact, the shift toward services is not a threat to Florida's sales tax base, because the production of retail goods and retail services are both growing at about the same rate. Goods were 39 percent of GDP in 1990, and 38 percent in 1999, whereas services were 52 percent of GDP in 1990 and 53 percent in 1999.¹⁰ Employment in the service sector is growing much more rapidly than employment in manufacturing, but manufacturing output and service output are growing at about the same rate, because increases in productivity have been concentrated in manufacturing, so each manufacturing worker can produce more output. The shift toward service employment from manufacturing employment is not relevant to the sales tax, because output is taxed, and manufacturing output is keeping up with the growth in Florida's economy.

Florida's economy is especially service-oriented, but this is also irrelevant to Florida's sales tax, because the tax is levied on what is purchased in Florida, not what is produced in Florida. Even if Florida's economy produced only services, the sales tax is still levied on the goods that people buy in Florida. For example, if an automobile is produced in Detroit and sold to a service worker in Florida, the buyer pays Florida sales tax. If a DVD player is made in Taiwan and sold to a service worker in Florida, the buyer pays Florida sales tax.

When one looks at the actual tax revenues collected in Florida, there is no evidence that a shift to services has negatively impacted Florida's sales tax. Without a services tax, in 1990-91 Florida's sales tax collections were 2.8 percent of personal income in Florida. By 1999-00 sales tax collections had grown to 3.4 percent of personal income.¹¹ Looking at the data, there is no evidence that Florida's future sales tax revenues are threatened by the growth in services, or that the state government's fiscal health will be imperiled if Florida does not extend its sales tax to services.

Are Retail Services Worth Taxing?

The previous section shows that Florida does not need to tax services to keep state revenues growing along with Florida's economy. The section before that noted that taxing non-retail services will be harmful to Florida's economy. If these two propositions are accepted, then the question becomes whether it is desirable to extend Florida's sales tax to cover those retail services that are not currently taxed. There is enough variation in the types of services that are not now taxed that it makes sense to consider them on a case-by-case basis. For example, medical care is currently not taxed, and many argue that for equity reasons it should remain untaxed.¹² Other types of services, such as lawn care and child care, may be provided by people who are small independent contractors who would find sales taxation burdensome enough that they might leave the business (or evade the tax). One can start a lawn care service by buying a lawnmower or two, a trailer, and a few other pieces of equipment. People who do so may have a strong work ethic and a desire to succeed in their businesses, but may have limited education and little in the way of accounting and bookkeeping skills. Many service jobs are that way, and when one realizes how little revenue taxing them would bring to the state, it may make sense to allow people to provide services without being burdened by having to collect taxes from their customers. Teenagers who cut the lawns of their neighbors for a fee would either have to negotiate the tax laws, evade the tax, or give up their business. Babysitters who did not collect sales tax for their services would be tax evaders. For some types of retail services, Florida might be better off leaving them untaxed.

Advocates of a tax on services argue that haircuts, dry cleaning, and lawn care should be taxed the same way that goods are taxed, and for the most part this is a sound argument. But in some cases this may eliminate an entire segment of the market, as noted in the previous paragraph, and at any rate, the amount of revenue that would be raised by taxing retail services (excluding health care) would be small. While advocates use examples like the ones above to make their cases, in most proposals the bulk of the revenues from a services tax would come from the taxation of non-retail services.

One issue that has lurked around the debate over a services tax, but is rarely stated explicitly, is the additional tax revenue that a services tax could raise. In hearings the Florida House of Representatives held around the state in 2002 on the services tax, proponents tended to be from groups that spend tax revenues, such as local governments and teachers' organizations, while opponents tended to be those who pay the taxes and those who favor more limited government. If one believes that Florida's government is underfunded, then it is reasonable to look at extending the sales tax to services, despite the inefficiencies noted above. All taxes have disadvantages. If one believes that Florida's government is adequately funded, there are no compelling reasons to support the extension of the sales tax to services, and many reasons to see a services tax as undesirable.

Political Considerations

Because the political debate over the services tax is tightly intertwined with the issue of the overall level of taxation, economic arguments are difficult to separate from the political positions they support. Some service tax supporters argue that Florida's current tax structure is not designed to accommodate the shift the economy is making toward goods rather than services, but the facts do not support this argument. Florida's sales tax base has been keeping up with Florida's economic growth, and despite the shift in employment from manufacturing to services, the output of goods is growing at about the same rate as the output of services. Florida does not need to tax services to have its state revenue continue to grow along with the state's economy. Whether the state should be spending more or less than it currently spends is a question well beyond the scope of this article.

A services tax that would be capable of raising any substantial amount of additional revenue would have to tax non-retail services such as accounting and legal services, advertising, and consulting services. There is not much revenue to be gained from extending the current sales tax only to retail services, and from a political standpoint, nobody is going to go out on a limb to support a services tax unless it will mean substantially more revenue.¹³ As a result, the main economic issue underlying a services tax is that it would result in tax pyramiding because it would fall mostly on non-retail services.

Footnotes

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¹ Both equity and efficiency would be more rigorously defined in a textbook on public finance. See, for example, Randall G. Holcombe, *Public Finance: Government Revenues and Expenditures in the United States Economy* (Minneapolis/St. Paul: West, 1996), chs. 10-11, for a more detailed discussion. Equity is often summarized in two principles: the benefit principle, which says that people should pay taxes in proportion to the benefits they receive from government expenditures; and the ability to pay principle, which says that people's tax burdens should be determined by their ability to pay. These principles have some ambiguity inherent in them, and sometimes the benefit principle and ability to pay principle conflict with each other. In a political context, one might argue that fair taxes are taxes that citizens agree are fair.

² The concept of efficient taxation implies that the tax structure should interfere as little as possible with the market allocation of resources, and that the invisible hand of the market leads to the optimal allocation of resources. There is substantial evidence that this is the case. See, for examples, David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich, and Some So Poor* (New York: W.W. Norton, 1998); James Gwartney, Randall Holcombe, and Robert Lawson, "The Scope of Government and the Wealth of Nations," *Cato Journal* 18, no. 2 (Fall 1998), pp. 163-190; and by the same authors, "Economic Freedom and the Environment for Economic Growth," *Journal of Institutional and Theoretical Economics* 155, no. 4 (December 1999), pp. 643-663.

³ A sales tax is never neutral because it discourages retail purchases, which is inefficient, but accepting this inefficiency as an inherent characteristic of sales taxation, the neutrality goal would argue for a sales tax that does not discourage some retail purchases more than others.

⁴ Florida does not tax the retail sale of groceries, prescription drugs, and some other retail goods, but does tax the non-retail sales of construction supplies, business equipment (such as computers), business supplies, and many other non-retail sales. All states do this to a degree, as Raymond J. Ring, Jr., "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," *National Tax Journal* 42 (June 1989), pp. 167-179, shows. Nearly one-third of Florida's sales tax revenues

are collected on non-retail sales. One way to reduce the taxation of non-retail sales would be to give all retail sellers a tax ID number and allow purchasers with tax IDs to be exempt from sales taxes. This is done in Virginia, for example. However, with no state income tax, one might expect that Florida would have tax a greater proportion of non-retail sales than states that do have income taxes.

⁵ For a description of Florida's sales tax, see *2001 Florida Tax Handbook*, published by the Florida legislature. It also gives a brief history, and lists exemptions along with an estimated cost to the state from each exemption.

⁶ The exemption for clothing was removed in 1957, and a one percent sales tax was placed on automobiles in 1957. The rate on automobiles was increased to the rate for all goods in 1971. Groceries remain exempt from sales taxation.

⁷ Chapter 212 of the Florida Statutes, which defines Florida's sales tax, has added sections to apply the tax to other sales, such as admissions, transient rentals, service warranties, and other transactions, so the tax is not as purely a tax on the retail sale of tangible goods as it once was. See Randall G. Holcombe, "Principles for Florida's Sales Tax," James Madison Institute *Background*, Policy Report # 29, November 2000, for a more detailed discussion and analysis of Florida's sales tax.

⁸ Taxes on transportation, which mostly is shipping of goods, would have composed 11 percent of the new tax revenues under McKay's plan, and financial services would have made up about 5 percent. Again, these would mostly be passed along to final purchasers, and taxed again. These figures come from analysis done by the Florida Senate to explain their plan. See John M. McKay, *Reforming Florida's Tax System: Building a Foundation for Florida's Future* (Tallahassee: Florida Senate, 2002).

⁹ Proponents of a services tax argue that it would be charged to in-state purchasers of services, regardless of who they bought from, and not charged on out-of-state purchases from Florida firms. However, multi-state firms would find it easier to avoid paying the services tax if they used accounting and legal firms from other states, which would undoubtedly send many high-paying professional service jobs out-of-state.

¹⁰ Statistics for income and output used in this section are calculated from the *Statistical Abstract of the United States*, 120th ed. (2000), p. 453.

¹¹ The rate remained at 6 percent throughout the 1990s. These figures do not include local option sales taxes that are levied in some counties. See Randall G. Holcombe, "Florida's Tax Structure: An Overview and Evaluation," James Madison Institute *Backgrounders*, Policy Report # 27, October 2000, p. 11 for a more complete calculation of Florida's sales tax burden.

¹² An argument might be made for taxation too. Most people do not pay for medical care directly, but rather through insurance of some type, so a sales tax on medical services would for the most part be a tax on health insurance. Many uninsured people have low incomes and do not pay for their medical care because caregivers are unable to collect, or because government programs such as Medicaid pay, so the sales tax would not affect them. Following this line of reasoning, there is not a strong equity rationale for exempting health care from Florida's sales tax.

¹³ The 2002 sales tax reform advocated by Senate President John McKay was promoted as a revenue-neutral tax reform, but McKay openly stated that the reason he wanted to put that reform through was that it would raise more sales tax revenue in future years.