



## TAX REFORM SERIES

# BROADENING MISSOURI'S SALES AND USE TAX BASE

VOLUME 1

# SERVICE TAXATION

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## Introduction

Americans celebrate the fact that tax reform was the catalyst for the birth of the United States. The Boston Tea Party on December 16, 1773, a taxpayer revolt of great import, directly challenged the oppressive tax policies of the British government. Tax policy was also vitally important to our founding fathers that recognized the power of taxation must be harnessed to serve the needs of the common good without negatively impacting its citizenry. James Madison, debating an import tax to support the new federal government in the first Congress on April 8, 1789, said, "... national revenue must be obtained; but the system must be such a one, that, while it secures the object of revenue it shall not be oppressive to our constituents."<sup>1</sup>

Tax policy remains fundamentally important to all levels of government and taxpayers. Government needs tax revenue to support its various functions and taxpayers bear the burden of taxes. Often, taxpayers complain taxes are more burdensome than necessary and government leaders can nearly always find uses for more tax revenue. The key challenge faced by policy makers is striking a balance between the necessity to fund the true needs of government and the burden placed on its individual and corporate citizens that must pay the tax bill.

From time to time, the method of taxation employed by state and federal governments is questioned and suggestions are made for improvements to the tax structure. In Missouri, some policy makers have recently claimed erosion of the sales and use tax base has reached a point that demands a complete overhaul of the sales and use tax system. One concept often mentioned in this debate is the focus of this series: broadening the sales and use tax base.

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<sup>1</sup> "*Annals of Congress*", 1<sup>st</sup> Cong., 1<sup>st</sup> sess., 107.

## Broadening the Tax Base = Tax Increase

What does “broadening the tax base” mean? Prominent American journalist Art Buchwald once said, “Tax reform is taking the taxes off things that have been taxed in the past and putting taxes on things that haven’t been taxed before.” He has perfectly described the impact of broadening the sales and use tax base.

“Broadening the tax base” means expanding sales and use taxes to transactions that are not taxed under the current sales and use tax law. The tax base may be broadened through expansion of the tax base to include additional transactions, such as services, or by eliminating tax exemptions. Broadening the tax base will result in a tax increase on transactions that were formerly untaxed, just as increasing the tax rate will result in a tax increase on all transactions in the tax base. The definition of “tax increase” contained in the Missouri Constitution bolsters this conclusion:

*“The term “increase taxes or fees” means any law or laws passed by the general assembly after May 2, 1996, that increase the rate of an existing tax or fee, impose a new tax or fee, or **broaden the scope of a tax or fee to include additional class of property, activity, or income**, but shall not include the extension of an existing tax or fee which was set to expire.”<sup>2</sup>*

This constitutional provision requires base broadening measures to be treated as tax increases when deciding whether voter approval is required. If the base broadening measure results in a net increase in taxes collected and the amount of such increase exceeds the allowable increase in tax revenue under Article X of the Missouri Constitution, the measure requires voter approval.

Most of the discussion regarding broadening Missouri’s tax base is coupled with a suggestion that the overall sales and use tax rate be lowered. However, for reasons discussed later, reductions in tax rates tend to be temporary, causing many taxpayers to view any expansion of the tax base as a net tax increase.

Because broadening the base may result in a real or perceived tax increase, policy makers should approach broadening the base with the same caution they would employ when considering any other tax increase.

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<sup>2</sup> “Constitution of Missouri”, Article X, Section 18(e), subsection 2 (emphasis added).

## **Applying Sales and Use Taxes to Services**

One of the most effective methods employed by states to broaden the sales tax base is also the most controversial: taxing services.

Sales and use taxes in Missouri and most other states are levied on the purchase of tangible personal property and specifically enumerated taxable services. For goods to be taxed, they must be both tangible and personal property. Some services that are specifically subjected to sales and use taxes in Missouri include:

“(a) Sales of admission tickets, cash admissions, charges and fees to or in places of amusement, entertainment and recreation, games and athletic events;

(b) Sales of electricity, electrical current, water and gas, natural or artificial, to domestic, commercial or industrial consumers;

(c) Sales of local and long distance telecommunications service to telecommunications subscribers and to others through equipment of telecommunications subscribers for the transmission of messages and conversations, and the sale, rental or leasing of all equipment or services pertaining or incidental thereto;

(d) Sales of service for transmission of messages by telegraph companies;

(e) Sales or charges for all rooms, meals and drinks furnished at any hotel, motel, tavern, inn, restaurant, eating house, drugstore, dining car, tourist camp, tourist cabin, or other place in which rooms, meals or drinks are regularly served to the public;

(f) Sales of tickets by every person operating a railroad, sleeping car, dining car, express car, boat, airplane, and such buses and trucks as are licensed by the division of motor carrier and railroad safety of the department of economic development of Missouri, engaged in the transportation of persons for hire.”<sup>3</sup>

The lease and rental of tangible personal property is also taxed if the sale of such property would be taxable.

## **Sales Tax Revenues Are Increasing**

Proponents argue policy makers should expand the tax base to services to reverse a perceived downward trend in sales tax revenues. But Missouri’s revenue collection data for the last 20 years show an increase in sales tax revenues each year except three fiscal years in which the loss in revenue may be attributed to special circumstances (see Figure 1). And data from other states show states that tax fewer services than Missouri actually experienced greater sales tax revenue growth than Missouri.

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<sup>3</sup> Section 144.010, subsection 1, subdivision (10), RSMo. See also section 144.020, RSMo.

In 1989, the U.S. Supreme Court ruled<sup>4</sup> states are unable to tax federal retirees' income while exempting all or a portion of state retirees' income. The Court ruled federal and state retirees must be treated equally. Because many states, including Missouri, exempted all or a portion of their retired state employees' income, but taxed all income of federal retirees, federal retirees were eligible for tax refunds. Lawmakers enacted a temporary two-tenths percent sales tax that was effective from October 1, 1989, through June 30, 1990, along with other temporary revenue measures, generating tax revenue with which the refunds could be paid. This temporary tax increase elevated sales and use tax collections for the state's 1990 fiscal year, resulting in a year-to-year loss in fiscal year 1991. Beginning October 1, 1997, policy makers reduced the sales tax on food by exempting the 3 percent general revenue portion of the tax, resulting in a loss in fiscal year 1998. In fiscal years 2000, 2001 and 2003, motor vehicle sales and use tax revenues declined over the previous year and in fiscal year 2003, the growth in other sales and use tax revenues was insufficient to completely offset the motor vehicle sales and use tax loss, resulting in a loss for fiscal year 2003.

**Figure 1**

<b>Missouri General Sales and Use Taxes</b>					
<b>Fiscal Year</b>	<b>Sales</b>	<b>Use</b>	<b>Motor V</b>	<b>Total</b>	<b>Growth</b>
2004	\$1,063,390,406	\$708,926,937	\$314,849,243	\$2,087,166,586	4.88%
2003	\$1,011,509,711	\$674,339,807	\$304,212,712	\$1,990,062,230	-0.56%
2002	\$1,010,261,132	\$673,507,422	\$317,555,617	\$2,001,324,171	1.66%
2001	\$1,009,788,086	\$673,192,057	\$285,676,494	\$1,968,656,637	0.13%
2000	\$1,000,219,787	\$666,813,191	\$299,022,325	\$1,966,055,303	5.38%
1999	\$933,700,801	\$622,467,201	\$309,475,002	\$1,865,643,004	1.09%
1998	\$934,034,089	\$622,689,393	\$288,726,261	\$1,845,449,743	-2.09%
1997	\$975,862,253	\$650,574,835	\$258,480,764	\$1,884,917,852	5.40%
1996	\$924,371,065	\$616,247,377	\$247,654,003	\$1,788,272,445	5.01%
1995	\$881,630,258	\$587,753,506	\$233,602,369	\$1,702,986,133	6.90%
1994	\$823,377,274	\$548,918,182	\$220,802,024	\$1,593,097,480	9.08%
1993	\$765,173,052	\$510,115,368	\$185,216,898	\$1,460,505,318	5.26%
1992	\$730,078,646	\$486,719,098	\$170,690,943	\$1,387,488,687	2.85%
1991	\$711,932,937	\$474,621,958	\$162,439,561	\$1,348,994,456	-0.93%
1990	\$726,798,273	\$484,532,182	\$150,329,718	\$1,361,660,173	8.95%
1989	\$662,562,973	\$441,708,648	\$145,571,333	\$1,249,842,954	4.98%
1988	\$629,798,041	\$419,865,360	\$140,883,251	\$1,190,546,652	3.63%
1987	\$607,842,230	\$405,228,154	\$135,738,562	\$1,148,808,946	5.76%
1986	\$572,688,810	\$381,792,540	\$131,799,772	\$1,086,281,122	5.51%
1985	\$543,871,553	\$362,581,035	\$123,132,456	\$1,029,585,044	6.24%
1984	\$514,362,026	\$342,908,017	\$111,865,369	\$969,135,412	

Source: Missouri Department of Revenue, Comprehensive Annual Financial Report for each fiscal year.

Preliminary data for the 2005 and 2006 fiscal years also show growth in sales and use tax revenues. The general revenue sales tax rate has not increased since 1963, except the

<sup>4</sup> *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 809 (1989).

1989-1990 temporary rate increase mentioned earlier<sup>5</sup>. This regular growth in sales tax revenues over the last 20 years reflects an increase in the value of the tax base.

## **Comparison with Other States**

The Federation of Tax Administrators (FTA) published a survey of states' taxation of services in 1996 and updated the report in 2004<sup>6</sup>. This survey is helpful in analyzing the impact of service taxation on tax revenues.

Proponents contend taxing more services will help Missouri keep its tax base intact in the wake of a shift from the purchase of tangible personal property to services. They point out that if a greater percentage of total expendable income is spent on services that are not taxed, Missouri's tax structure will falter if the base is not expanded to services.

But if exclusion of services from a state's tax base causes deficiency in tax collections, one would expect Missouri's growth in tax collections to be stronger than in states with a lower number of taxed services. In fact, of states that taxed fewer services than Missouri, all but one experienced greater per capita growth in sales tax revenues than Missouri over the past 10 years (1996-2005). In addition, nearly all states taxing fewer services than Missouri had stronger growth in overall sales tax revenues for the 10-year period. Some states that tax more services even experienced less growth than in Missouri. For example, New Mexico taxes 156 services while Missouri taxes only 28, but Missouri's growth in per capita sales tax revenue was greater than in New Mexico and growth in overall sales tax revenue was about the same in both states. Figure 2 shows the data for each state.

While the world economy is certainly becoming more service-oriented due to the explosion of technology, the sale of tangible personal property that is included in Missouri's sales and use tax base continues to provide a stable source of tax revenue for state and local governments.

## **Sales Tax Percentage of Total Tax Burden**

Supporters of service tax increases point to a shrinking percentage of Missouri's total tax revenue that is derived from sales taxes, implying that if Missouri increased its taxation of services, the percentage would increase. However, a review of the data shows that taxing more services is not a cure for this phenomenon and supports the fact that the dwindling importance of sales and use taxes is a national trend. In the United States, the average percentage of total state tax revenue derived from sales taxes declined from 1996 to 2005. In Connecticut, Maryland, Georgia, West Virginia, Utah, New Mexico, Vermont and Wyoming, the percentage of total tax revenues from general sales taxes decreased more than in Missouri from 1996 to 2005 in spite of the fact all of these states taxed more services than Missouri. Figure 3 shows the percentage of total tax revenue attributable to sales taxes and the percent change over the 10-year time frame.

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<sup>5</sup> "Missouri Historical Tax Summary, January 2005", Appendix A, State and Regional Fiscal Studies Unit, Research Center, University of Missouri-Columbia.

<sup>6</sup> "Sales Taxation of Services", Federation of Tax Administrators, 2004.

**Figure 2. Growth in Sales Tax Revenue 1996-2005**

<b>State</b>	<b>Services Taxed</b>	<b>Per Capita Growth</b>	<b>Total Sales Tax Growth</b>
Hawaii	160	3.79%	4.66%
Washington	157	2.97%	4.49%
New Mexico	156	1.10%	2.47%
South Dakota	146	4.85%	5.54%
West Virginia	110	3.62%	3.61%
Idaho	94	5.24%	7.42%
Texas	81	2.64%	4.77%
Connecticut	80	2.67%	3.48%
Nebraska	76	6.91%	7.72%
Mississippi	74	3.09%	3.95%
Wisconsin	74	3.78%	4.56%
Arizona	72	4.09%	7.53%
Kansas	71	3.37%	4.01%
Ohio	68	5.46%	5.75%
Minnesota	67	3.10%	4.25%
Tennessee	67	5.01%	6.36%
Florida	62	3.53%	5.97%
Wyoming	62	5.96%	6.65%
Arkansas	58	6.10%	7.53%
Utah	58	2.06%	4.35%
New York	56	4.61%	5.30%
Louisiana	55	6.17%	6.66%
New Jersey	55	3.79%	4.78%
Pennsylvania	55	3.57%	3.94%
Maryland	39	3.04%	4.23%
Alabama	37	3.24%	3.94%
Georgia	36	1.34%	3.78%
South Carolina	34	3.32%	4.81%
Oklahoma	32	2.76%	3.63%
Illinois	30	3.27%	4.03%
North Carolina	30	3.05%	5.02%
Kentucky	29	3.42%	4.26%
Rhode Island	29	5.86%	6.88%
Vermont	29	5.61%	6.32%
<b>Missouri</b>	<b>28</b>	<b>1.48%</b>	<b>2.36%</b>
North Dakota	27	4.47%	4.35%
Michigan	26	1.91%	2.35%
Maine	24	3.46%	4.18%
California	23	3.79%	5.27%
Iowa	23	1.52%	1.98%
Massachusetts	19	4.02%	4.62%
Virginia	18	3.59%	5.06%
Indiana	17	5.58%	6.43%
Nevada	15	-0.52%	4.17%
Colorado	14	2.50%	4.85%

Sources: U.S. Census Bureau, Federation of Tax Administrators.

**Figure 3. Sales Tax Percentage of All State Taxes 1996-2005**

<b>State</b>	<b>Services Taxed</b>	<b>1996ST%</b>	<b>2005ST%</b>	<b>% CHG</b>
Hawaii	160	46.50%	48.18%	1.69%
Washington	157	58.40%	61.64%	3.24%
New Mexico	156	41.95%	34.81%	-7.14%
South Dakota	146	52.51%	56.02%	3.51%
Delaware	143	0.00%	0.00%	0.00%
West Virginia	110	28.84%	25.47%	-3.37%
Idaho	94	32.32%	38.46%	6.14%
Texas	81	50.02%	49.89%	-0.14%
Connecticut	80	31.22%	28.21%	-3.02%
Nebraska	76	34.39%	39.95%	5.56%
Mississippi	74	47.45%	47.64%	0.19%
Wisconsin	74	28.25%	30.03%	1.78%
Arizona	72	42.44%	47.31%	4.87%
Kansas	71	35.21%	35.56%	0.35%
Ohio	68	31.89%	34.13%	2.24%
Minnesota	67	28.31%	26.47%	-1.84%
Tennessee	67	57.24%	61.14%	3.90%
Florida	62	57.93%	56.22%	-1.71%
Wyoming	62	41.59%	30.02%	-11.57%
Arkansas	58	37.17%	39.28%	2.11%
Utah	58	40.28%	36.50%	-3.78%
New York	56	20.39%	21.92%	1.53%
Louisiana	55	33.06%	33.12%	0.07%
New Jersey	55	30.02%	28.57%	-1.45%
Pennsylvania	55	31.16%	29.58%	-1.58%
Maryland	39	24.49%	21.41%	-3.08%
Alabama	37	27.37%	26.07%	-1.31%
Georgia	36	37.15%	33.87%	-3.28%
South Carolina	34	37.54%	39.67%	2.13%
Oklahoma	32	26.21%	24.21%	-2.00%
Illinois	30	28.89%	27.24%	-1.64%
North Carolina	30	25.00%	24.69%	-0.31%
Kentucky	29	27.49%	28.54%	1.05%
Rhode Island	29	29.93%	32.11%	2.18%
Vermont	29	21.70%	13.86%	-7.85%
<b>Missouri</b>	<b>28</b>	<b>34.19%</b>	<b>31.82%</b>	<b>-2.38%</b>
North Dakota	27	28.63%	29.23%	0.60%
Michigan	26	35.22%	34.32%	-0.90%
Maine	24	34.69%	30.44%	-4.25%
California	23	32.87%	30.44%	-2.42%
Iowa	23	32.79%	29.94%	-2.85%
Massachusetts	19	20.96%	21.60%	0.64%
Virginia	18	22.42%	19.43%	-2.99%
Indiana	17	33.99%	38.91%	4.92%
Nevada	15	54.28%	45.01%	-9.28%
Colorado	14	27.41%	26.19%	-1.22%
<b>UNITED STATES AVERAGE</b>		<b>33.31%</b>	<b>32.76%</b>	<b>-0.55%</b>

Sources: U.S. Census Bureau, Federation of Tax Administrators.

## Taxing Services – Experiences of Other States

According to the FTA<sup>7</sup>, “no state has undertaken a broad-based expansion (of service taxation) since Florida in 1987 and Massachusetts in 1990, which were both later repealed.” The Nebraska Legislature also greatly expanded the Nebraska sales tax base by increasing the number of taxed services in 2002 and 2003.

### *Nebraska*

In 2002, Nebraska increased the sales tax rate “temporarily” from 5% to 5.5%<sup>8</sup> and expanded the sales tax base to some services in an omnibus tax increase bill that was, according to the Legislative Research Division of the Nebraska Legislature, “a contentious bill at virtually every step in the legislative process.”<sup>9</sup> The bill was passed, vetoed by the governor, the veto was overridden by the legislature, and a little more than one week later, the press reported that a citizens’ referendum was underway to repeal the bill. The Nebraska Legislature enacted sales taxes on even more services the following year (2003), including repair and maintenance services and contractor labor services.

While these changes expanded the tax base by 25% over the two year period, the increase was short-lived as the Nebraska sales tax base actually decreased from 2004 to 2005, resulting in a loss of about \$8 million in 2005 tax revenue over 2004. Whether this decrease was related to the burden on the economy resulting from the increased sales tax rate, the expansion of sales taxes to more service transactions, or other factors is not known. But increasing the rate and expanding the tax base certainly do not appear to have improved the sales tax situation for Nebraska taxpayers or tax collectors.

### *Florida*

Whenever the subject of sales taxation of services is considered, one of the first thoughts must be the experience of Florida. Florida’s experience with service taxation was high profile, politically charged, and serves as an example to other states that wish to expand their tax base to services. Florida’s experience teaches that the issue should be approached carefully with respect for potential political and technical problems, and perhaps even a limited measure of trepidation.

One of the architects of the Florida service taxation plan, Walter Hellerstein, recapitulated Florida’s experience in an article immediately following the repeal of the unpopular tax plan.<sup>10</sup> According to Hellerstein, Florida looked to base expansion as a means of financing a “State Comprehensive Plan”.

In June 1986, the Florida Legislature passed a broad-based service tax bill in the “closing hours of the 1986 legislative session” that would have applied Florida’s full sales tax of 5% to the amount charged for any service effective July 1, 1987. The delayed effective

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<sup>7</sup> “*Tax Administrators News*”, Federation of Tax Administrators, May 2005.

<sup>8</sup> Although the “temporary” sales tax rate increase was originally intended to last only one year when enacted in 2002, the sales tax rate remains at 5.5% in 2006.

<sup>9</sup> “*A Review: Ninety-Seventh Legislature Second Session, 2002*”, Nebraska Legislature, Legislative Research Division, May 2002.

<sup>10</sup> “*Florida’s Sales Tax on Services*”, Walter Hellerstein, *National Tax Journal*, Vol. 41, No. 1, March 1988.

date allowed the legislature to pass another bill during the 1987 session that was signed into law on April 23, 1987, and was, like the previously enacted legislation, effective July 1, 1987.

The 1987 law imposed sales and use taxes on many services, including construction, accounting, legal, and advertising services. Some of Florida's problems with taxing services resulted from constitutional and political challenges to the tax on certain services. For example, the sales tax on legal services was challenged by attorneys on the grounds that a tax on legal services violated clients' right to counsel. The taxes were imposed on sales of services outside Florida's borders, raising obvious tax situs and nexus questions and due process and Commerce Clause concerns. The imposition of tax on advertising raised First Amendment issues, burdening the right of free speech.

One may expect such questions from organized groups of constituents, but the general public was also upset with the changes. Confusion and frustration surrounded implementation of the tax and its proper administration by businesses. According to Hellerstein, national advertisers cancelled advertising in protest and business groups cancelled some 60 conventions in the state. Lawyers, homebuilders and realtors joined the media in an organized fight against the tax. Tax protesters reenacted the first American tax revolt by pouring instant tea into Florida's harbors.

Florida Governor Robert Martinez was a one-term governor elected in 1986. He was originally affiliated with the Democratic party and switched to the Republican party prior to his election as governor. Martinez was only the second Republican elected to the Florida governor's office at that time since Reconstruction. Governor Martinez initially supported and signed the two pieces of legislation expanding the sales tax to services. Because of the public outcry against the tax, the governor switched his position and, after much political debate, signed legislation repealing the service tax effective January 1, 1988, and enacting a 1% increase in the general sales and use tax rate.

**Figure 4. Florida Service Tax Timeline**

June 1986	Florida's legislature expressed their intent to extend the sales tax base the following year by passing a law that broadened the sales tax base to all services effective July 1, 1987.
April 23, 1987	Governor Robert Martinez initially supported and signed legislation expanding the sales tax to many services.
July 1, 1987	Sales and use taxes on services was effective. The tax applied to accounting, advertising, contracting, and legal services. The sales taxes were apportioned for multi-state firms, and exemptions were enacted for various governmental, educational, agricultural, and social services, as well as the isolated or occasional provision of services and services provided to businesses for the purpose of resale.
August 1987	Governor Martinez called for a referendum on the tax while claiming to personally support the tax.
September 1987	Governor Martinez reversed his support of the tax on services and favored full repeal of the service sales and use tax.
October 1987	The Florida legislature passed a bill that removed advertising from the tax base, but Governor Martinez vetoed the bill.
December 11, 1987	Florida's legislature passed legislation repealing the 5% tax on services and increasing the general sales tax rate by 1% to recover the loss in revenue. Governor Martinez immediately signed the repeal.

Source: "Florida's Sales Tax on Services", Walter Hellerstein, *National Tax Journal*, Vol. 41, No. 1, March 1988.

The Florida service sales and use tax lasted only six months, but the impact would set the tone for other state legislatures and bureaucrats that have considered applying their sales tax to services. Some believe they can dodge the problems created in Florida by avoiding the specific services that were the source of the legal questions and public outrage in that state. But those considering such a tax must be ready to offer up services that could be taxed without causing a political firestorm from the industries that are subjected to the tax increase and the general public.

### ***Massachusetts***

Florida's broad taxation of services was short-lived, but Massachusetts' was momentary in comparison. Massachusetts faced a desperate budget situation in 1990 when Governor Michael Dukakis signed into law a sales tax on services that was billed as a tax on business-to-business services. In fact, the tax applied to all services, including accounting, legal, engineering, financial, plumbing and landscaping services.<sup>11</sup> The tax was originally to be effective December 1, 1990, but the effective date was delayed until March 6, 1991, at the request of then Governor-Elect William Weld.<sup>12</sup> The legislature repealed the tax in a bill that was signed on March 8, 1991, with a retroactive effective date to March 6, meaning the tax never really took effect.

Although the broad service tax was repealed, some portions of the tax were allowed to become effective and remain in effect today, including the sales tax on utilities and telecommunications services.<sup>13</sup>

## **Trends in Missouri Service Expenditures**

Advocates of taxing more services in Missouri claim the shift in the economy from a manufacturing base to a service oriented base and citizens' purchases through electronic commerce makes Missouri's tax base instable. They suggest one way to increase the stability of the tax base is to broaden the tax base to include more services.<sup>14</sup>

An evaluation of the relative values of purchased goods and services, and whether those goods and services are included or excluded from the current sales tax base, is helpful when evaluating the risks and benefits of increasing the sales tax on services. National personal consumption expenditure (PCE) data aid in mapping consumer purchases of a wide array of goods and services. For the purposes of this study, it is assumed that the national trends in purchases of goods and services are similar to trends of Missouri purchasers. Overlaying these national data with Missouri's current sales tax structure also helps us assess the stability of the current Missouri tax base.

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<sup>11</sup> Citizens for Limited Taxation, January 19, 1999.

<sup>12</sup> "Tax on Services", Securities Industry Association.

<sup>13</sup> "TIR 91-5: Effect of Repeal of Sales Tax on Services", Commonwealth of Massachusetts, Department of Revenue, June 28, 1991.

<sup>14</sup> "Missouri's Fiscal Crisis Remains Severe: Revenue Options are Available as Compared to Continued Spending Cuts", Missouri Budget Project, January 2004.

The national PCE data are divided into expenditures for goods and services. Services are further divided into subcategories, and in some cases data are available for specific services.

We further allocated the national service PCE data into five broad categories: real property rentals, services specifically exempted from Missouri tax, services partially taxable under Missouri law, services already taxable under Missouri law, and potentially taxable services.

**“Real property rentals”** include “housing” expenditures in the federal data. Nearly all expenditures in this category represent expenditures for rentals of real property. Sales tax is normally levied on tangible personal property, not real property.<sup>15</sup>

**“Services exempted from Missouri tax”**, as the name implies, includes services that are specifically excluded from Missouri’s sales and use tax base. Because a statutory exemption indicates policy makers have previously considered taxing these services and decided to exempt them, it seemed appropriate to show these expenditures separately. Expenditures in this category include household utilities (electricity, gas, and water services).<sup>16</sup>

The **“partially taxable under Missouri law”** category represents expenditures for services that include some taxable component under current Missouri law. The federal PCE data were not specific enough to accurately divide the expenditure into “taxable” or “exempt”. Examples of items in this category include expenditures for auto repair, television and radio repair, cleaning and repair of clothing, because parts and materials included in these expenditures are currently taxable in Missouri.

Expenditures designated **“taxable under Missouri law”** include expenditures for telephone services and places of amusement.

Policy makers could apply sales taxes to the remaining service expenditures in the **“potentially taxable services”** category. This is the broadest category and includes expenditures for domestic services, doctors, dentists, hospitals, insurance, legal services, public transportation services, club dues, higher education, private elementary and secondary schools, trade schools, and other expenditures. While policy makers may tax these expenditures, other states’ experiences indicate their taxation may raise legal and/or moral questions and would almost certainly be politically controversial.

The percentage of total personal consumption expenditures represented by each of these categories is shown in Figure 5.

While service taxation advocates claim a large increase in the proportion of expenditures allocated to untaxed services, the table in Figure 5 shows only a slight increase in the

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<sup>15</sup> One subcategory in the federal “housing” category contained expenditures for hotels, motels and travel accommodations which are taxable under current Missouri law. Because the subcategory also contained expenditures for school housing and other non-taxable expenditures, expenditures in this subcategory were allocated to the “partially taxable” category in this analysis.

<sup>16</sup> Although these services may be subject to local sales tax in some local taxing jurisdictions, they are exempted from state sales and use taxes.

percentage of all expenditures representing potentially taxable services. Over the ten year period 1996-2005, potentially taxable services increased from 29.2% to 30.9% of all personal consumption expenditures. While these data confirm a shift has occurred in the spending habits of consumers, the increase in these expenditures does not appear to indicate a structural problem with the tax base. Also, since expenditures for insurance, doctors, hospitals and other health care costs are included in the “potentially taxable” category, a portion of the increase may be attributed to the disproportionate increase in the costs of these services, even though policy makers probably would not view the taxation of these expenditures as excellent sources of sales tax revenue because of the moral and political implications.

**Figure 5. Percentage of Total Personal Consumption Expenditures**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>Real Property Rentals</b>	14.4%	14.4%	14.4%	14.3%	14.1%	14.5%	14.5%	14.3%	14.3%	14.1%
<b>Specifically Exempted from Missouri Tax</b>	3.3%	3.2%	3.0%	2.9%	2.9%	3.0%	2.8%	2.9%	2.9%	3.0%
<b>Partially Taxable Under Missouri Law</b>	9.5%	9.8%	9.8%	9.9%	9.9%	9.6%	9.4%	9.4%	9.4%	9.3%
<b>Taxable Under Missouri Law</b>	2.1%	2.2%	2.2%	2.2%	2.2%	2.1%	2.1%	2.0%	1.9%	1.8%
<b>Potentially Taxable Services</b>	29.2%	29.2%	29.4%	29.3%	29.4%	29.8%	30.3%	30.7%	30.9%	30.9%

Source: “National Income and Product Accounts, Table 2.5.5”, revised August 2, 2006, U.S. Department of Commerce, Bureau of Economic Analysis

So, if services were subjected to sales taxes in Missouri, which services would be taxed and which would be excluded? Taxing health care and insurance would decrease affordability when most policy makers seem to want to make those items more affordable. And any increase in the taxation of services may make the tax more regressive, especially when the purchasing habits of consumers are taken into consideration. For example, a lower income family may be more likely to fix and keep the family car, while a higher income family may decide to purchase a new car. If the sales tax is extended to repair services, the proportional tax burden will be increased on the lower income family that is more likely to repair than replace their vehicle.

Taxing business inputs increases production costs for businesses initially and eventually increases the burden on consumers through increased prices. For this reason, policy makers in other states have avoided taxing business-to-business services. The experience of other states shows us taxing legal services would lead to claims that access to the legal system would be limited. Taxing advertising raises constitutional free speech questions.

National advocates of taxing services say expanding the taxation of services will make the sales tax fairer. But even those advocates acknowledge that increasing the sales tax on services potentially increases the regressive nature of the sales tax: the impact on lower income individuals could be greater than on higher income individuals. They suggest other ways of offsetting the increase in regressivity, including hiking individual income tax rates.<sup>17</sup> Perhaps the best way to avoid increasing the regressive nature of the sales tax is to avoid the temptation to tax additional services in the first place.

<sup>17</sup> “Expanding Sales Taxation of Services: Options and Issues”, Michael Mazerov, Center on Budget and Policy Priorities, June 19, 2003.

## **Policy Makers Should Be Sure Before Making Any Change**

The administrative burden on businesses and the purchasing public caused by major changes in the tax base demands policy makers make sure they really want to tax additional services before they implement such a radical change in the tax base. A case in point is the administrative difficulty that was experienced by retailers and the public when policy makers made the last major change in the sales tax base: the exemption of state sales tax on the sale of non-prepared food in 1997. The confusion of retailers and tax administrators in the Missouri Department of Revenue was so great the law was amended in an attempt to address many of the problems in 1999. But many food retailers are still confused and experiencing difficulty with applying the tax correctly even 9 years after its initial passage.

### **Temporary Nature of Rate Reductions**

Although policy makers often mention an overall sales tax rate reduction to offset the increase in tax burden that would result from expansion of the tax base, policy makers are cautioned that history teaches us “permanent” rate cuts tend to be temporary and “temporary” tax hikes tend to be permanent.

As noted earlier, to raise revenue with which to pay refunds due federal retirees under the 1989 U.S. Supreme Court decision in *Davis v. Michigan*, policy makers enacted a “temporary” increase in the corporation income tax. The corporation income tax rate for corporations with taxable incomes over \$100,000 and less than \$335,000 was boosted from 5% to 6% and for corporations with income above \$335,000, the rate was increased from 5% to 6.5%, effective January 1, 1990. These temporary tax increases expired, as originally intended, on January 1, 1992. The next legislative session, in an effort to increase public education funding, policy makers decided that because corporations had already been paying 6.5% during the federal retiree refund crisis, increasing the tax burden on corporations would not cause major problems. Lawmakers passed an increase in the tax rate from 5% to 6.25%, effective September 1, 1993.

This experience reinforces the fear of taxpayers that any increases in tax are permanent and reductions in tax only temporary. If a tax has recently been reduced and government leaders decide they need more money (and they often do), increasing a recently reduced tax seems more politically acceptable than increasing taxes elsewhere. In addition, lawmakers in the past have been hesitant to “tie the hands” of future legislatures by enacting permanent tax reductions.

Policy makers should avoid the political “smoke and mirrors” and carefully consider that even if they intend to reduce the rates, there is a good chance any rate reduction will be temporary. Policy makers should treat any expansion of the tax base, even if coupled with a corresponding tax rate reduction, as they would any other tax increase.

## Conclusion

“Broadening the tax base” will result in a tax increase. Even if coupled with a decreased sales and use tax rate, such rate decrease is likely to be only temporary. For this reason, policy makers must evaluate measures that broaden the base in the same manner as they would any other tax increase.

Broadening the base through the expanded taxation of services is the most commonly mentioned, and most controversial, way to broaden the tax base. Missouri taxes only a limited number of services under current law.

Advocates cite base broadening measures as a way to shore up tax collections, but Missouri sales and use tax revenues have experienced steady growth in all but a few exceptional years. Implementing a broad tax on services to improve sales tax revenue growth may not accomplish the intended result. Despite taxing fewer services, Missouri has experienced revenue growth at least as strong as other states that tax more services, both in terms of the overall growth in sales and use tax revenue and in the percentage of tax revenue derived from sales and use taxes.

The experience of other states should also be examined. Nebraska experienced short-lived temporary growth from a tax increase bill that expanded the tax base to many services over a two-year period. Florida also enacted, and then quickly repealed, a broad-based sales tax on services. Massachusetts had an even briefer experiment with service taxation. In all these states, the decision to tax services was extremely controversial, yielded little net revenue benefit, ignited constitutional challenges, and in most cases was reversed after implementation, leaving tax collectors and taxpayers confused and taxpayers angry.

If the decision is made to tax services, the tax is likely to become more regressive, affecting lower income individuals more than higher income individuals, especially if the tax is extended to labor and service charges. The types of services that could be taxed in Missouri could very likely be contrary to other public policy efforts to improve the accessibility of health care, reduce the tax burden on business inputs, and even efforts to make the sales and use tax a “fairer” tax.

Missouri policy makers should carefully consider all the potential consequences before pursuing an expansion of the sales and use tax base to services. The benefits do not appear to outweigh the potentially serious negative effect on taxpayers and the employer community. The political and moral implications of such a change must be considered in light of the experience of other states and policy makers’ ultimate goal of fairer taxation and stability in the Missouri sales and use tax base.