**Testimony in support of HB 1628, Sales and Use Tax - Rate Reduction and Services**

Committee on Ways and Means, Maryland House of Delegates
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Chair Kaiser and members of the committee,

I strongly support passage of HB 1628.

In doing so, I am appearing on behalf of myself, and not for my employer, UMBC. However, my support for expanding the sales tax base is consistent with the beliefs of most academics who specialize in government budgeting and finance. In particular, I want to recognize the late John Mikesell of Indiana University, the world's expert on sales taxation; I had the privilege to speak in his memory at last fall's conference of the Association for Budgeting and Financial Management.

Mikesell's classic text on *Sales Taxation*[1], and his extraordinary consulting work for state and international governments[2], strongly argued for the expansion of the sales tax base from its traditional focus on goods to include many services that are consumed by the public.

The logic is simple. First, expanding the tax base increases the fairness of the tax, reducing the economic distortions created by imposing the tax mostly on purchased goods. If you are going to fund essential government activities by taxing consumption, it makes no economic sense to, for example, tax the purchase of golf clubs, while not taxing the purchase of lessons from a golf pro. The jargon for this inconsistency is "horizontal inequity."

Second, expanding the base can facilitate a reduction of the sales tax rate. The lower the tax rate, the less likely it is that the tax will cause people to consume differently than they would prefer. While it is good policy in a few cases to use high rates in hopes that people will change their consumption--as is the case with tobacco and alcohol--we should avoid creating that negative incentive for most goods and services.

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[1] John F. Due and John L. Mikesell, 1983. *Sales Taxation: State and Local Structure and Administration*. Baltimore: Johns Hopkins University Press.

[2] See, for example, John Mikesell, 2017. "Considering Sales Taxation of Services in Indiana," Indiana Fiscal Policy Institute, March 29.

This approach of “broaden the base and reduce the rate” was central to the landmark federal Tax Reform Act of 1986--a bill that is one of the great legacies of conservative icon President Reagan and liberals such as Senator Bill Bradley. It’s a great example of how good policy can be enacted when politicians reach across the aisle. While that behavior is pretty rare in Washington these days, it still should be a good option in Annapolis, particularly because many conservative policy analysts, such as the Tax Foundation, also believe that expanding the sales tax base is wise tax policy.[3]

If you are familiar with the Tax Reform Act, you know that the bill was designed to be revenue neutral. You might instead decide to use sales tax base expansion to contribute to the elimination of projected deficits.

MD always seems to begin each fiscal year with a deficit, whether small or large. Both the legislature and the governor have taken deserved credit in recent years for eliminating that deficit, but those successes have generally been limited to the budget year, with outyear projections showing growing deficits.

In addition, DLS has warned that the potential for a recession is increasing, and current events certainly point that way. Adding an economic slowdown to the baseline deficit projection shows a $1.7 billion gap in FY25--not counting any additional spending for local education aid. Part of that gap is due to the declining revenue yield from the narrow sales tax base, because each year the typical consumer shifts the ratio of purchases between taxed goods and untaxed services towards the latter.

Expanding the sales tax base to services can counteract that revenue loss, helping to close the deficit over time.[4] The competitive space for this tax policy is real, since MD’s revenue collections, relative to personal income, rank it 39th highest in the nation.[5] Dropping the sales tax rate to 5% would also leave Maryland’s rate below those of Pennsylvania, West Virginia, Virginia, and the District of Columbia, and reduce the difference with Delaware, which has no sales tax.

Another problem relevant to this bill is that MD’s revenue structure has above average volatility from year to year, because of the state’s reliance on the income tax. The exclusion of some capital gains revenues from tax projections may have slightly reduced the effects of this volatility. Unfortunately, among experts there isn’t a consensus on whether taxing more services reduces volatility--some say it does, some say it doesn’t. If the effect is positive, it is likely to be small.

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[3] Nicole Kaeding, 2017. “Sales Tax Base Broadening: Right-Sizing a State Sales Tax,” Tax Foundation, October.

[4] Reconsidering some current exemptions from the sales tax on goods could also help reduce deficits.

[5] 2017 data. https://www.taxadmin.org/2017-state-and-local-revenue-as-a-percentage-of-personal-income

Also contested among experts is whether expanding the tax base to services will increase or reduce the regressivity of the sales tax. Again, the effects are likely to be small in either direction. But if the added funds are used for programs that expand opportunities for the poor and middle class, then the consequential impact of the tax will be progressive.

Sales tax base expansion would undoubtedly reduce sales tax regressivity if it were limited to those services that are consumed primarily by high-income consumers. But doing so would greatly limit the revenue yield. On the other hand, you should be wary of applying the tax to services that are purchased primarily by other businesses that then sell goods or services which are subject to the sales tax. This would create a problem called tax "pyramiding" or "cascading," leading to an undesirably high effective tax rate.

While pure business-to-business services should be excluded from the sales tax, you should not go too far with such exclusions. There are some services, which we call "dual-use services," that are consumed by both businesses and households. Michael Mazerov has produced an excellent analysis of how to deal with this difficulty of deciding what should be taxed and what should not be taxed.[6] He also discusses possible evasion by businesses, recommending that states apply the use tax to business purchases of taxable services from out-of-state.

You have undoubtedly heard already from advocates who argue that they should be exempted from this bill's coverage, and there are many more to come. Some opponents will make false claims of double taxation. Others will provide you with exaggerated elasticity estimates of reduced spending due to the tax. These are unlikely from just a 5% increment in the price of services. If such effects were likely, then we should already have seen suppliers of taxed goods go out of business because of the sales tax--but obviously they have not.

However, it is understandable that some service providers will be concerned that a services sales tax will force them to bear a new administrative burden. Because of this, I believe the effective date of January 2021 is too soon. Expanding sales tax collection to new vendors, and particularly to small businesses, is a complicated task, and the Comptroller will need more time to do this well.

In conclusion, the policy rationales for thoughtfully expanding the sales tax base are very strong. As a political scientist, I am almost as aware as you are that the politics of enacting this bill are difficult--if you are to support this approach, you will need to explain the reasons why it is good policy. That you would also be cutting the sales tax rate will help. You should also be able to take credit for providing Maryland state government with a stronger revenue foundation.

Thank you for considering these suggestions. I would be glad to answer any questions you have.

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[6] Michael Mazerov, 2009. "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, July.