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March 2, 2020

Maryland General Assembly
House Ways and Means Committee

Re: COST's Opposition to House Bill 1628, Sales and Use Tax – Rate Reduction and Services

Dear Chair Kaiser, Vice Chair Washington, and Members of the Committee:

Thank you for the opportunity to provide testimony today on behalf of the Council On State Taxation (COST) in opposition to House Bill 1628 (H.B. 1628), Sales and Use Tax – Rate Reduction and Services, which would inappropriately expand the application of Maryland's sales tax to many business inputs without an exemption for business-to-business transactions. Business inputs constitute intermediate, not final, goods and services because companies either resell these goods and services or use the materials, products, machinery and services to produce other goods or services that subsequently are sold to households.

COST does not generally oppose legislation that broadens a state's sales tax base to business-to-*consumer* transactions. However, H.B. 1628's proposed sales tax expansion to include services—many of which are predominantly provided to businesses, without providing an exemption for business inputs—directly violates the economic principle that an ideal sales tax should tax household consumption and not business inputs.[1]

If this legislation passes, Maryland would be the first state in decades—and the only large population state ever—to impose such an expansive sales tax on business inputs. There are only a few smaller-population and non-industrialized states that long ago enacted a broad-based sales tax on services ((*e.g.*, South Dakota, Hawaii, and New

[1] *See* Andrew Phillips and Muath Ibaid, Ernst & Young LLP, "The Impact of Imposing Sales Taxes on Business Inputs," prepared for the State Tax Research Institute and the Council On State Taxation (May 2019), available at: https://www.cost.org/globalassets/cost/stri/studies-and-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf; John L. Mikesell, "Reversing 85 Years of Bad State Retail Sales Tax Policy," State Tax Notes (February 4, 2019); Robert Cline, Andrew Phillips and Tom Neubig, Ernst & Young LLP, "What's Wrong with Taxing Business Services? Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services," prepared for the Council On State Taxation (April 4, 2013), available at: https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/sales-taxation-of-services-and-business-inputs-study.pdf; Analysis of Proposed Changes to Select Ohio Taxes Included in the Ohio Executive Budget and Ohio House Bill Number 64, issued in 2015, available at: https://cost.org/globalassets/cost/stri/studies-and-reports/analysis-of-proposed-changes-to-select-ohio-taxes-included-in-the-ohio-executive-budget.pdf.

Mexico). One can hardly imagine a worse signal to the national business community, demonstrating that Maryland is business unfriendly and not competitive.

Historically, most states, including Maryland, have included in their sales tax base a broad range of goods, but only a limited range of services. With the rapid growth of the services sector in recent decades, it is understandable why a state would want to expand its sales tax base to include more service categories. However, H.B. 1628 expands the sales tax base not only to include a wide range of services consumed by households, but also to an even wider range of services consumed by businesses. In recent years, there have been similar broad-based proposals in several states such as Louisiana, Minnesota, and Ohio to significantly expand the sales tax to include services, and the share of the additional tax that would be imposed on business inputs was estimated to be as high as 80%.[2] The disproportionate burden that would be imposed on businesses by H.B. 1628 has been acknowledged by the Maryland Department of Legislative Services. In its Fiscal and Policy Note on H.B. 1628, the Department reached the following conclusion: "It should be noted that many of the categories of services that are estimated to generate significant revenue under the bill, including business services, professional services, and information services, are services that are largely consumed by businesses."[3]

The Maryland Department of Legislative Services also noted the historic failure of all other sales tax base broadening proposals that included a wide range of business services, compared with the more incremental approach taken by many other states that limited the base expansion largely to services purchased by households: "A number of states, including Louisiana, Massachusetts, Michigan, Nebraska, Pennsylvania, and Utah, have proposed significantly broadening their sales tax bases, including to professional services, but none have been successful. Meanwhile, Connecticut, the District of Columbia, Iowa, Kentucky, and North Carolina have taken incremental steps to broaden the application of their sales and use taxes to additional services."[4]

Maryland would do well to heed the lessons of other state efforts to broaden the sales tax base and limit the expansion to household services only. To do otherwise, will encumber the State with a draconian expansion of the sales tax base to business inputs and make Maryland an outlier among all states in terms of its divergence from the principles of a fair and efficient sales tax. This, in turn, will undermine all of the State's efforts to raise revenues for state and local government programs while still fostering a healthy environment for business investment and job growth. While we understand that the legislative intent of H.B. 1628 is to broaden the base and lower the sales tax rate, the proposed rate reduction does not mitigate COST's concerns regarding the expansion of the tax base to business-to-business transactions.[5]

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an

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[2] Cline, Phillips, Neubig, "What's Wrong with Taxing Business Services? Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services," 15-17.
[3] Department of Legislative Services, Maryland General Assembly, "Fiscal and Policy Note" on House Bill 1628, 5, available at: http://mgaleg.maryland.gov/2020RS/fnotes/bil_0008/hb1628.pdf.
[4] *Id.* at 4.
[5] Businesses will certainly benefit from the sales tax rate reduction on the business inputs that are currently taxed under Maryland law. But since the business share of purchased services included in sales tax base broadening legislation is generally much larger than the business share of purchased goods subject to sales tax, H.B. 1628 is likely to lead to a substantial net increase in sales tax paid by businesses in Maryland.

advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 550 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Policy Against Imposing State Sales Tax on Business Inputs

The COST Board of Directors has adopted a formal policy position opposing the imposition of state sales tax on business inputs, which provides.[6]

> *Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.*

H.B. 1628 is inconsistent with creating a more efficient and modern sales tax system. Imposing sales tax on business inputs specifically violates the tax policy principles of neutrality, equity, simplicity and transparency, and it causes significant economic distortions. Taxing business inputs is inconsistent with the rationale for a sales tax designed to operate as a tax only on final household consumption; because businesses are not the final consumers of business input purchases, the sales tax should not apply to their purchases.[7]

Notably, these distortions result primarily from pyramiding. Pyramiding occurs when a tax is imposed at multiple levels that results in a hidden effective tax rate that exceeds the retail sales tax rate. Pyramiding forces companies to either pass these increased costs on to consumers or reduce their economic activity in the State to remain competitive with other producers who do not bear the burden of such increased taxes. Because of these choices, the economic burden of taxes on business inputs inevitably shifts to labor in the State (through lower wages and employment) or consumers (through higher prices).

H.B. 1628 would create other significant adverse economic distortions from the current taxation of business purchases in Maryland. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax (vertical integration);

- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;

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[6] Available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/sales-taxation-of-business-inputs.pdf.

[7] Andrew Phillips and Muath Ibaid, Ernst & Young LLP, "The Impact of Imposing Sales Taxes on Business Inputs," prepared for the State Tax Research Institute and the Council On State Taxation (May 2019), available at: https://www.cost.org/globalassets/cost/stri/studies-and-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf.

- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales;

- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services; and

- Taxing business inputs increases administrative and compliance costs for tax administrators and taxpayers.

Finally, sales taxes on business services, in particular, create significant cost disadvantages for small businesses. Small businesses are often less likely than large businesses to be able to vertically integrate. Without the means to compete with larger businesses that can vertically integrate and internalize certain costs, the demand for services provided by small businesses is reduced. Moreover, increased administrative and compliance costs are another strain for small businesses to absorb.

H.B. 1628 Would Undo Much of the Benefit of Maryland's Legislative Shift to a Single Sales Factor

Ironically, Maryland's recent tax policy has moved in a diametrically opposite direction with regard to understanding the importance of providing a tax structure that encourages in-state production and investment. For corporate income tax purposes, Maryland has recognized the value of relying on consumption rather than production tax principles as a central tenet of sound tax policy by shifting the apportionment formula for its corporate net income tax to rely almost wholly on the sales factor. By removing the property and payroll factors from the corporate apportionment formula, Maryland is taxing businesses not based on the jobs or investment in the State, but only based on their proportion of sales into the State. To then turn around and enact sweeping sales tax base broadening legislation, the burden of which will fall largely on businesses, will move Maryland in the exact opposite direction, penalizing businesses for investing, making purchases, and creating jobs in Maryland.

H.B. 1628 Would Negatively Impact Maryland's Sales Tax Scorecard Grade

In April 2018, COST released a Scorecard evaluating "The Best and Worst of State Sales Tax Systems."[8] The Sales Tax Scorecard graded states on the administration of their respective state and local sales and use taxes. Like other COST scorecards, it is meant to help improve tax administrative systems which will ultimately increase compliance. The Sales Tax Scorecard objectively evaluates state statutes and administrative rules that govern the administrations of the states' sales taxes by the states' taxing agencies. COST's scorecards are ultimately directed at policymakers, who are in the best position to make improvements to the state's sales tax through statutory changes. In the Sales Tax Scorecard, COST considered the following categories:

- The extent of taxation of business inputs or pyramiding of the sales taxes;

- Fair sales tax administrative practices;

[8] Available at: https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/the-best-and-worst-of-state-sales-tax-systems-august-17-2018-final.pdf.

- Uniformity of state and local sales tax bases and centralized administration;
- Simplification and transparency of the sales tax;
- Reasonable tax payment and credit administration; and
- Fair audit and refund procedures.

Considering these categories, Maryland received a "C" grade. If H.B. 1628 passed, however, Maryland's grade would definitely be impacted adversely. Specifically, its grade would likely be lowered to a "D+," significantly lowering its ranking amongst the other states to become one of the lowest ranked states. H.B. 1628 would directly impact Maryland's score in the categories evaluating the taxation of business inputs and pyramiding of the sales tax. H.B. 1628 will significantly increase Maryland's percentage of state and local sales tax derived from business-to-business transactions, which currently is estimated at 42 percent. By way of comparison, South Dakota and New Mexico, two of the states that tax the broadest range of services (without exemptions for business inputs), also have the highest share of state and local sales taxes derived from taxing business inputs at 58 percent and 60 percent, respectively.

For these reasons, COST urges members of the Committee to please vote "no" on H.B. 1628.

Respectfully,

Stephanie T. Do

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director