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spotlight

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Reforming the Sales Tax

Keep in mind liberty, prosperity, and sound principles of taxation

KEY FACTS: **• Over the past year the focus of North Carolina's Joint Legislative Committee on Tax Reform has been almost exclusively on whether to expand North Carolina's sales tax to include services.**

• Sound principles of tax reform suggest that North Carolina's sales tax base should be broadened in some areas and narrowed in others.

• The focus should be on whether the tax base is what economists call neutral, and whether the tax conforms with the principles of justice, rooted in a respect for liberty and freedom of choice.

• In North Carolina, both business-to-consumer and business-to-business sales are taxed.

• Sound principles of taxation argue that both goods and services be taxed but taxed only once and in a manner obvious to the taxpayer. Sales taxes on all business-to-business sales should therefore be abolished.

• Some goods and services in NC are taxed at extraordinary rates. While the sales tax rate in North Carolina is 5.75% (plus 2% or more additional in most localities), movies and other entertainment, alcoholic beverages, tobacco products, hotel rooms, and rental cars are all taxed at higher rates. In a free society, the tax system should not be used to punish activities that are disfavored by the politicians or to reward activities that the politicians consider virtuous.

• At a combined average state and local rate of 7.98 percent, North Carolina's sales tax rate is virtually tied with Tennessee's rate of 8 percent as the highest in the Southeast.

During the 2009 legislative session the North Carolina General Assembly formed its Joint Finance Committee on Tax Reform (JFCTR). Over the past year the focus of the committee has been almost exclusively on reforming North Carolina's sales tax. What *reform* in that area has meant to the JFCTR apparently has been extending the current sales tax to services,

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such as haircuts and lawn and automotive care. At present the tax applies only to goods.

To reduce the impact of base broadening on the taxpayer and, more likely, to make the change politically palatable, the JFCTR also suggests that the base broadening be coupled with cutting the rate. But altering the sales tax in the ways the JFCTR is considering would not be about tax reform, but instead tax expansion for the ultimate purpose of increasing revenues.

The JFTCR: tax reform without a purpose

The committee's actions are consistent with the language used by the legislature in setting up the committee. The directive from the legislature simply states that:

> The President Pro Tempore of the Senate and the Speaker of the House of Representatives authorize the Finance Committees of the Senate and the House and other designated members to meet during the interim to study and recommend legislation to reform North Carolina's sales and income tax structure in order to broaden the tax base and lower the State's tax rates.[1]

While using the term "reform," this language simply directs the JFCTR to come up with recommendations for a particular set of changes. It gives no indication that the changes be rooted in what anyone who has rigorously thought about tax reform would recommend in such an unqualified manner.

The directive does not address whether such changes would be sensible in terms of making the tax system more efficient from an economic perspective or more just from an ethical perspective. In other words, it gives no reason for making those changes.

With respect to the sales tax, the issues of whether broadening the tax base to include services is appropriate andwhether, in some areas, the base might actually be too broad are apparently beyond the scope of the JFCTR's work. The committee's directive offers no hint about why broadening the sales tax base, or the base for any other tax, would be appropriate or a good idea. In other words, it gives no indication of what the ultimate purpose is.

The directive also states that the recommendations should combine broadening the tax base with cutting the rate, also with no explanation. It is fair to speculate that the proposed rate cut is intended simply to add a spoonful of sugar, politically speaking, to help the base-broadening medicine go down with the electorate. The political truth is that it is easier to increase tax revenues when a rate is applied to a larger base. The larger the base, the smaller any given increase in the rate need be in order to raise the same amount of revenue.

With respect to the state sales tax, when the purchases of services are taxed along with the purchases of goods, a much smaller (and therefore politically more palatable) rate increase would be required to bring in the same amount of new revenue. So even if the rate were decreased in the short run to offset all or some of the revenue gains from an increase in the tax base, the dynamic reality is that going forward it would be easier for politicians to raise a given amount of revenue because the rate hike needed to accomplish the task woul not need to be as large.

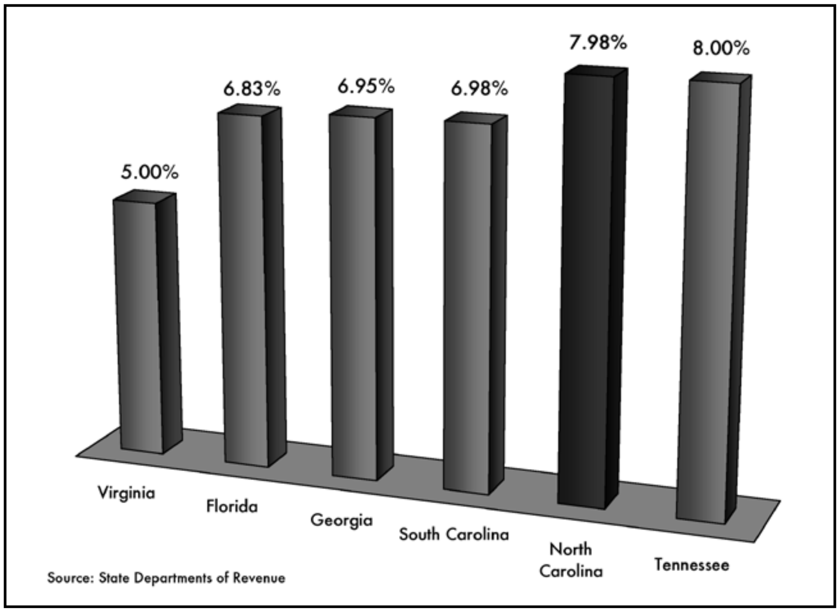
The revenue generating possibilities of expanding the sales tax to services was pointed out in testimony to the JFCTR by Michael Mazerov from the Washington, D.C.–based Center for Budget and Policy Priorities. He stated that "there is enormous revenue raising potential in the sales taxation of services." In fact, Mazerov estimates that North Carolina could raise an additional $1.5 billion a year by extending the current sales tax to services purchased by households.[2]

For those concerned that the size and scope of state government is already too large, that approach to tax reform should be alarming. It is a recipe for increasing taxes in the long run and expanding an already bloated state government.

Reforming the tax base

It is certainly not that sales tax reform should be abandoned — indeed, appropriate reform would entail changes in the tax base. But the tax base changes would not be all in the same direction. Sound principles of tax reform suggest that North Carolina's sales tax base should be broadened in some areas and narrowed in others. Whether it would result in a net broadening or narrowing of the base is unclear but ultimately irrelevant.

North Carolina's combined state and local sales tax rate is nearly as high as Tennessee's, a state with no income tax



The focus of tax reform should be on whether the tax base is what economists call *neutral* (i.e., not constructed so that it penalizes some purchases and rewards others) and that it conforms with principles of *justice* that are rooted in a respect for liberty and freedom of choice. Those two concerns go hand-in-hand. Neutrality implies that the government is not using the tax system to manipulate freely made choices.

In addition to neutrality and justice the system should avoid hidden taxes. In a democracy, people need to be aware of how much their government costs them, which they can do only if they are aware of the taxes they are paying. In other words, the taxes they pay should not be hidden. All taxes should be transparent to the taxpayer.

The sales tax in North Carolina violates all three principles. For example, because of its *overly* broad tax base, people who pay the sales tax are actually double-taxed on the products that they purchase. This aspect of the tax is not just hidden, but also it penalizes the purchase of some products more than others. Double taxation occurs because business-to-consumer and business-to-business sales are both taxed.

For example, a consumer who buys a bottle of shampoo at a drug store pays state and local sales tax on the price of the purchase. The drug store, however, has already paid a sales tax on all of the products and equipment that went into providing the shampoo to the customer: the cash register, the shelving in the store, the credit card equipment, etc. The cost of those items, including the sales tax, is embedded in the price of the shampoo. Therefore, the customer, in paying sales tax on the shampoo, is being taxed on taxes already paid. Hence, the shampoo to the customer is double taxed.

First, it is clear that those taxes are hidden from the consumers paying them. No line item on the sales receipt shows how much of the price is actually sales tax that had already been paid on business purchases made by the retailer. In other words, the statutory sales tax understates the actual sales tax paid by the customer.

The sales tax also penalizes consumer products whose production involves more business-to-business purchases than others. In other words, while it is difficult to know which products are more adversely affected than others, it is clear that these hidden layers of taxes embedded in final prices will effect final products differentially.

Upon consideration of those facts, it becomes readily apparent that even services are not going completely untaxed, since all of the goods that go into providing those services — i.e., lawn mowers to a lawn service and hair clippers to a hair salon — are subject to the sales tax. Those taxes are included in the price of the service. In this sense services are already being taxed.

Also, violating the principles of both neutrality and justice, there are many goods and even services that are taxed at extraordinary rates. While the sales tax rate in North Carolina is 5.75% (plus 2% or more additional in most localities), movies and other entertainment, alcoholic beverages, tobacco products, hotel rooms, and rental cars are all taxed at higher rates.

In a free society, the purpose of a tax system is simply to raise money for the operations of government. It should not be used to punish activities that are disfavored by the politicians or to reward activities that the politicians consider virtuous. It should also not be used disproportionately to tax products that have what economists call *inelastic demand.* Such products are essentially such things as rental cars, most customers of which come from out of state and are often here on business; or cigarettes, where an addiction is involved; and other items on which a higher tax can be applied simply because politicians know they can get away with it, such as on activities that people consider special and are therefore willing to pay a little more for, such as theater tickets.

In those cases the tax either falls on people who have no voting power or causes little decrease in quantity demanded. Indeed, principles of both justice and economic efficiency would suggest that the tax system should be neutral with respect to people's freely made choices, even if those choices are frowned upon by a large proportion of society.

The implications for reform of North Carolina's sales tax are straightforward. Sound principles of tax reform suggest that both goods and services be taxed but taxed only once and in a manner obvious to the taxpayer. Sales taxes on all business-to-business sales should therefore be abolished. In other words while expanding the tax base to services, many goods currently being taxed should be removed from the base.

These same principles of tax reform should also be applied to products that are singled out for special penalties such as those mentioned above. These goods and services should be taxed at no greater rate than other products subject to the sales tax. This disproportionate tax treatment is inconsistent with freedom and represents an unwarranted interference with private decision-making.

Tax Rate

Regardless of whether the existing base is changed, North Carolina's sales tax rate is excessive. At a combined average state and local rate of 7.98 percent, North Carolina's rate is virtually tied with Tennessee's rate of 8 percent as the highest in the Southeast. But that is misleading since Tennessee has no income tax. And North Carolina's rate is a full percentage point above the third highest, South Carolina.

Furthermore, N.C.'s rate was well above Florida's 6.8 percent, even though Florida, like Tennessee, has no income tax. North Carolina's punitive sales tax rate imposes a tax penalty on living and doing business in the state when compared with the tax rates of surrounding states.

This high rate goes directly to the issue of tax justice discussed above. North Carolina's constitution recognizes the right of its citizens to "enjoy the fruits of their own labor"[3] — their income is a fundamental right. In other words, justice dictates that people be able to keep what they earn, unmolested by the tax collector. Since all taxation, to some degree, abridges this right, North Carolina's excessive sales tax rates are an affront to justice — especially given that N.C. also has the highest income tax rates in the region.

As an aside, economic analysis of taxation argues that the approach of Tennessee and Florida makes sense. That is, consumption taxes should be relied upon to raise revenues for the government. Income taxes penalize investment, saving, entrepreneurship, and therefore economic prosperity. Broad-based consumption taxes, even though (like all other taxation) they impose an economic loss to the state by transferring resources from the private to the public sector, do not add insult to injury by penalizing productive activities per se.[4]

Conclusion

In a free society, the principles discussed here should weigh the heaviest on those legislators charged with reforming North Carolina's tax system. Considerations of tax reform should always start with first principles. And in a free society, those first principles are individual liberty and the right of each person to dispose of his or her income as he or she sees fit.

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End Notes

1. Study of North Carolina's Sales and Income Tax Structure, Interim Joint House and Senate Finance Committees, *http://www.ncleg.net/documentsites/committees/jhsfctr/Homepage/index.html*.
2. See Michael Mazerov "Sales Taxation of Services: Options and Issues," presentation to the Interim Joint House and Senate Finance Committees, North Carolina General Assembly, December 1, 2009, *http://www.ncleg.net/gascripts/DocumentSites/searchDocSite.asp?nID=56&searchCriteria=mazerov*.
3. North Carolina Constitution, Article 1 (q.v., *http://www.ncga.state.nc.us/Legislation/constitution/article1.html*).
4. For a more extended discussion of this analysis see Roy Cordato, *Tax Reform in North Carolina*, Nathaniel Macon Research Series No. 4, the John Locke Foundation, March 2009, *http://www.johnlocke.org/policy_reports/display_story.html?id=196*.