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## Taxing Services

Randall G. Holcombe  
[rgh@rgh.com](mailto:rgh@rgh.com)

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# FLORIDA STATE UNIVERSITY LAW REVIEW



TAXING SERVICES

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# TAXING SERVICES

RANDALL G. HOLCOMBE\*

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## I. INTRODUCTION

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. All taxes discourage the taxed activity, thus altering people's economic choices.

One goal of tax policy is therefore to reduce inefficiencies in the tax system. Equity, on the other hand, is a more subjective goal of tax policy, but with respect to applying Florida's sales tax to services, one way to view equity is to seek similar treatment of goods and services under the sales tax.<sup>1</sup> 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.<sup>2</sup> A sales tax that taxes all retail purchases only once at the

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\* Devoe Moore Professor of Economics, Florida State University.

1. Both equity and efficiency are more rigorously defined in textbooks on public finance. See, for example, Chapters 10 and 11 of RANDALL G. HOLCOMBE, PUBLIC FINANCE: GOVERNMENT REVENUES AND EXPENDITURES IN THE UNITED STATES ECONOMY 206-49 (1996), 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. *Id.* at 231, 233. These principles have some ambiguity inherent in them, and sometimes the benefit principle and ability-to-pay principle conflict with each other. *See id.* at 234-35. In a political context, one might argue that fair taxes are taxes that citizens agree are fair. *See id.* at 246.

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, e.g.*, DAVID S. LANDES, THE WEALTH AND POVERTY OF NATIONS: WHY SOME

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.<sup>3</sup>

Florida's sales tax departs substantially from the ideal of neutrality. For instance, Florida does not tax many retail purchases, but does tax many non-retail purchases.<sup>4</sup> Services are treated differently from goods in Florida's sales tax; the tax was originally designed as a tax on the retail sale of tangible goods that excluded 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,<sup>5</sup> 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.

## II. ORIGINAL DESIGN OF FLORIDA'S SERVICE TAX

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. Section 212.05, *Florida Statutes*, states that its legislative intent is "that every person is exercising a taxable privilege who engages in the business of selling tangible personal property at retail in this state."<sup>6</sup> Originally, many goods were exempt

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ARE SO RICH, AND SOME SO POOR (1998); James Gwartney, Randall Holcombe, & Robert Lawson, *Economic Freedom and the Environment for Economic Growth*, 155 J. INSTITUTIONAL & THEORETICAL ECON. 643 (1999); James Gwartney, Randall Holcombe, & Robert Lawson, *The Scope of Government and the Wealth of Nations*, 18 CATO J. 163 (1998).

3. A sales tax is never neutral because it discourages retail purchases, which is inefficient. However, by accepting this inefficiency as an inherent characteristic of sales taxation, the proponent of a 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. FLA. STAT. § 212.08 (2002). Florida does tax the non-retail sales of construction supplies, business equipment (such as computers), business supplies, and many other non-retail sales. FLA. STAT. § 212.05(f). All states do this to a degree. See Raymond J. Ring, Jr., *The Proportion of Consumers' and Producers' Goods in the General Sales Tax*, 42 NAT'L TAX J. 167 (1989). Nearly one-third of Florida's sales tax revenues are collected on non-retail sales. See *infra* note 13 and accompanying text. 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. See VA. CODE ANN. § 58.1228 (Michie 2002). However, with no state income tax, Florida might be expected to tax a greater proportion of non-retail sales than states that have income taxes.

5. For a description of the evolution of Florida's sales tax, see FLA. S. FIN. & TAX'N COMM. ET AL., 2001 FLORIDA TAX HANDBOOK, 106-07 [hereinafter TAX HANDBOOK]. It also gives a brief history and lists exemptions along with an estimated cost to the state from each exemption. *Id.* at 106-17.

6. FLA. STAT. § 212.05.

from the tax, including automobiles, most clothing, and groceries.<sup>7</sup> A transaction is exempt if it would be taxed under the law absent a specific provision that makes it non-taxable.<sup>8</sup> For example, automobiles are tangible personal property, but the original law included wording to *exempt* them.<sup>9</sup> There was no exemption for services because they are not tangible goods, so they were *excluded* from the sales tax.<sup>10</sup> The terminology is relevant because exemptions and exclusions are often lumped together and referred to as exemptions in the discussion of the services tax. Yet services are not exempt from the sales tax; they are excluded.<sup>11</sup> 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.<sup>12</sup>

While services have historically been excluded from Florida's sales tax, there is no compelling reason for the sale 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: the taxation of non-retail sales results in double taxation, also known as tax pyramiding. This has been a key issue in the services tax debate in Florida, so it merits close examination.

### III. TAX PYRAMIDING

Tax pyramiding occurs when a transaction is taxed multiple times, as would happen if an intermediate good or service was taxed and then the final retail transaction that the intermediate good or service helped produce was also taxed. For example, business equipment is sales taxable, so when a business buys a computer, it pays sales tax. This purchase is a cost of doing business that 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

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7. The exemption for inexpensive clothing was removed in 1957, and a one percent sales tax was placed on automobiles in 1957. TAX HANDBOOK, *supra* note 5, at 106. The rate on automobiles was increased to the rate for all goods in 1971. *Id.* Groceries remain exempt from sales taxation. FLA. STAT. § 212.08.

8. *See, e.g.*, FLA. STAT. §§ 212.05(1)(a)(2), 212.05(1)(c)(1)(b), 212.05(1)(j)(3), 212.05(1)(k)(3); *see also* FLA. STAT. § 212.08.

9. Act effective Nov. 1, 1949, ch. 26319, 1949 Fla. Laws 26.

10. *See* FLA. STAT. § 212.05.

11. *See id.*

12. Chapter 212, *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, e.g.*, FLA. STAT. §§ 212.03 (transient rentals), 212.04 (admissions), 212.0506 (service warranties); *see also* Randall G. Holcombe, *Principles for Florida's Sales Tax*, 2000 JAMES MADISON INST. BACKGROUNDER 29 (presenting a more detailed discussion and analysis of Florida's sales tax).

(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,<sup>13</sup> 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 the example of an architect who contracts with an engineering firm for help with the architect's project. The engineer then hires a draftsman as an independent contractor to help with the engineer's work on the project. Presently the services of the architect, the engineering firm, and the draftsman are untaxed.

Now assume that a six percent sales tax is extended to the purchases of all services. The engineer must pay six 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, that cost includes the draftsman's contribution, on which another six percent sales tax is paid, for a total of twelve percent. The draftsman's work is also included in the final price the architect charges, resulting in yet another tax on the draftsman's work as well as a tax on the engineer's work. The end result is an eighteen percent sales tax on the draftsman's work, a twelve percent tax on the engineer's work, and a six percent tax 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 and would therefore lead to tax pyramiding. The 1987 services tax promoted by Governor Martinez would have resulted in 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.<sup>14</sup> Advertising is a cost of doing busi-

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13. This determination is based upon an assessment of Florida taxation statistics found in the 2001 *Florida Tax Handbook*. See TAX HANDBOOK, *supra* note 5. The *Tax Handbook* estimated total Florida Department of Revenue collections for the fiscal year 2001-2002 to be \$16,796,800,000, while it estimated resale exemptions derived from business purchases to be \$5,051,400,000. *Id.* at 104, 108. Thus, resale exemptions from business purchases account for approximately one-third of the total Department of Revenue collections in 2000-2001.

14. Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1 (1988).

ness 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 would have also created a substantial amount of tax pyramiding.<sup>15</sup> In McKay's plan, more than sixty percent of new revenues would have been generated by taxes on business and professional services, and less than six percent would have been from taxes on currently untaxed personal services.<sup>16</sup>

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 a six 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 upon how to avoid taxes rather than on the most efficient way to do business, so the tax is not neutral.

Furthermore, large firms would 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. Thus, tax pyramiding favors large businesses over small businesses, again violating the principle of neutrality. Additionally, a tax on business services would drive many smaller businesses out of Florida to states that do not tax services, causing a more direct harm to Florida's economy.<sup>17</sup>

While there may be a good argument for taxing retail services, 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

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15. See generally John M. McKay, *Reforming Florida's Tax System: Building a Foundation for Florida's Future* (2001) (unpublished manuscript, on file with Florida State University Law Review).

16. A calculation of figures provided to the author by the Florida Senate suggests that taxes on transportation, which fall most upon the shipping of goods, would have comprised eleven percent of the new tax revenues under McKay's plan, and financial services would have made up about five percent. Calculations from Figures Provided by the Florida Senate (on file with the author). Again, these would be passed for the most part on to final purchasers and would be taxed again.

17. Proponents of a services tax might argue that the service tax would be charged to in-state purchasers of services, regardless of who they buy from, and would not be 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.

that the sales tax should treat goods and services the same, so such services as haircuts, lawn care, and swimming pool maintenance should be taxed the same way as combs, lawn mowers, and swimming pool supplies.<sup>18</sup> 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 from business services taxing, not from retail services.

#### IV. THE SERVICE ECONOMY

Another argument 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.<sup>19</sup> In fact, however, 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 accounted for thirty-nine percent of the gross domestic product (GDP) in 1990 and thirty-eight percent in 1999, whereas services accounted for fifty-two percent of the GDP in 1990 and fifty-three percent in 1999.<sup>20</sup> 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, allowing each manufacturing worker to produce more output.<sup>21</sup> Thus, the shift toward service employment from manufacturing employment does not affect the sales tax because output, not employment, is taxed, and manufacturing output is keeping up with the growth in Florida's economy.

Florida's economy is especially service-oriented, but this also does not affect 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 would still only be 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 had a negative im-

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18. Opinion Editorial by John McKay, President of the Florida Senate 2 (Dec. 2001) (on file with the Florida State University Law Review) [hereinafter Opinion Editorial].

19. *See generally id.*

20. Statistics for income and output used in this section are calculated from the U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 453 (120th ed. 2000).

21. *See id.*



pact. In 1990-91, without a services tax, Florida's sales tax collections were 2.8 % of personal income in Florida.<sup>22</sup> By 1999-2000, sales tax collections had grown to 3.4 % of personal income.<sup>23</sup> Looking at the data, there is no evidence that Florida's future sales tax revenues are threatened by its growth in services or that the state government's fiscal health will be imperiled if Florida does not extend its sales tax to services.

#### V. ARE RETAIL SERVICES WORTH TAXING?

The previous Section demonstrated that Florida does not need to tax services to keep state revenues growing at pace with Florida's economy. The Section before that noted that taxing non-retail services will harm 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 presently taxed that it makes sense to consider them on a case-by-case basis. For example, medical care is currently not taxed, and many may argue that for equity reasons it should remain untaxed.<sup>24</sup> 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 so burdensome that they would consider leaving the business or evading the tax. One can start a lawn care service by buying a lawnmower, a trailer, and a few other pieces of equipment. Such people may have a strong work ethic and a desire to succeed but may have limited education and little in the way of accounting and bookkeeping skills. Many service jobs do not currently require tax sophistication, and when one realizes how little revenue would be raised by taxing people in such jobs, it may not make sense to burden such people by requiring them to collect taxes from their customers. Teenagers who cut lawns for their neighbors for a fee would either have to negotiate the tax laws, evade the tax, or give up their businesses. Babysitters who do not collect sales tax for their services

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22. Randall G. Holcombe, *Florida's Tax Structure: An Overview and Evaluation*, 2000 JAMES MADISON INST. BACKGROUNDER 27, at 11.

23. The rate remained at six percent throughout the 1990s. *Id.* These figures do not include local option sales taxes that are levied in some counties. *See id.* For a complete calculation of Florida's sales tax burden, see *id.* at 11.

24. An argument might also be made for taxation. Most people do not pay for medical care directly but instead pay 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 like Medicaid pay for them. The sales tax would not affect these uninsured people. Following this line of reasoning, there is not a strong equity rationale for exempting health care from Florida's sales tax.

would be tax evaders. Thus, Florida might be better off leaving some types of retail services 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,<sup>25</sup> and for the most part, this is a sound argument.<sup>26</sup> In some cases, however, this may eliminate an entire segment of the market, 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 state their cases, the bulk of the revenues from a services tax in most proposals 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 involves the additional tax revenue that a services tax could raise. In hearings on the service tax that the Florida House of Representatives held around the state in 2002, 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. However, 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 there are many reasons to see a services tax as undesirable.

## VI. 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 may argue that Florida's current tax structure is not designed to accommodate the shift the economy is making toward goods, 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 keep pace 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.

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25. See Opinion Editorial, *supra* note 18.

26. See *supra* note 2 and accompanying text.

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.<sup>27</sup> As a result, the main economic problem with a services tax is that it would result in tax pyramiding because it would fall mostly on non-retail services.

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27. The 2002 sales tax reform advocated by Senate President John McKay was promoted as a revenue-neutral tax reform. John McKay, *Reforming Florida's Tax Structure*, Address to Florida's Tax Reform Study Commission 4 (Nov. 14, 2001) (transcript on file with Florida State University Law Review). However, 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. *Id.* at 5.