

# Taxing Services: An Analysis of Retail Sales Tax Reform in North Carolina

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A Report for the North Carolina Office of State Budget and  
Management

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## **EXECUTIVE SUMMARY<sup>1</sup>**

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### **Policy Question**

Should North Carolina levy retail sales taxes on services to help bridge the expected 2011-2012 budget gap? If yes, which services?

### **Recommendation (p. 12)**

We recommend that the North Carolina Office of State Budget and Management (OSBM) include a retail sales tax on services as part of the proposed budget for 2011-2012. We recommend that North Carolina tax services that at least 30% of other states (15 states) currently tax (see Appendix II p.19 for a complete list of these services). Under this plan, the state will administer taxes at the state retail sales tax rate of 4.75%.

This plan will generate a net gain in revenue of \$778 million in its first full year of implementation. While any expansion of the tax base will inevitably meet resistance from the public, businesses, and politicians, the resistance to this option will be minimal compared to other proposals that tax services. This alternative is politically palatable due to the fact that it taxes services already taxed in other states. This alternative will not put North Carolina's businesses at a competitive disadvantage because many states already tax these services. The administrative costs for this alternative will be minimal.

### **Problem (p. 1)**

North Carolina's budget deficit for fiscal year 2011-2012 is projected to range from \$3.3 to \$4.4 billion. Contributing to this deficit is the expiration of \$1.4 billion in temporary taxes, the end of \$1.6 billion in federal stimulus funding, and approximately \$1 billion in flagging revenue. The historical, national shift away from household spending on tangible goods towards household purchases of services exacerbates North Carolina's current budget issues. This trend has caused states' sales tax bases to dwindle because states have historically not taxed services.

North Carolina taxes some services: 35 out of the 168 defined by the Federation of Tax Administrators. This is fewer than most states, and by not taxing services, North Carolina forgoes significant revenue.

Imposing a tax on services is politically difficult, particularly in North Carolina's current political climate. In the 2009 legislative session, the General Assembly passed several

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tax increases, but none included a tax on services. In fact, the North Carolina Senate proposed taxing services, but the concept gained little traction. Because 2010 is an election year, state legislators are unlikely to propose any expansion of the tax base this year. In addition, polls suggest that North Carolinians would prefer raising the sales tax rate to expanding the tax base to include services.

Taxing services will inevitably stir political backlash from service industries. Service industries in other states, such as Florida, Michigan, and Massachusetts, effectively lobbied to repeal tax reforms that included taxes on services.

The current tax system creates an incentive for consumers to favor untaxed services over taxed tangible goods, and therefore places a higher burden on those who consume goods. Higher income households spend a greater proportion of their income on services than lower income households do. Consequently, taxing services will reduce the tax burden gap between the rich and poor.

A tax on services may raise issues of economic efficiency depending on implementation. Taxing business-to-business services causes economic inefficiencies because it leads to “tax pyramiding” or “cascading.” This means that businesses pass the costs of the tax through to the final purchase price. Therefore, consumers pay the tax twice, and their relative tax burden increases. Taxing business-to-business services may also cause firms to relocate out of state, thereby hampering the state’s competitiveness.

While a tax on services could potentially introduce a considerable and stable source of revenue, there may be significant costs in its implementation. Taxing services will require the Department of Revenue to spend money updating its database as well as on enforcement and education.

### **Criteria (p. 6)**

- Increase state tax revenue by approximately \$1 billion per year, starting fiscal year 2011-2012 to help close the expected budget gap.
- Minimize resistance from members of the General Assembly, the North Carolina public, and service industries.
- Minimize economic inefficiency: 1) avoid price distortions and 2) ensure state competitiveness.
- Do not increase the gap in relative tax burdens between the rich and poor. Relative tax burden is the proportion of income spent on sales taxes. Currently the tax burden is higher for low-income individuals than for wealthy individuals.
- Minimize administrative costs for state government.

## Alternatives (p. 6)

Figure 1 shows revenue estimates for the first full year of implementation for the five alternatives considered in this report.

1. Tax services that at least 30% of other states currently tax. Administer taxes at the retail sales tax rate of 4.75%. Since North Carolina already taxes 35 of these services, the state will add 33 services to the tax base (see Appendix II p.19 for a complete list of these services. Appendix III p. 20 shows where North Carolina will rank relative to other states in number of services taxed under this alternative).
2. Tax 12 luxury services. Administer taxes at the retail sales tax rate of 4.75% (see Appendix IV p. 21 for a complete list of luxury services and taxable receipts).
3. Tax all non-exempt services at the retail sales tax rate of 4.75% (see Appendix V p. 22 for a complete list of all non-exempt services and taxable receipts).
4. Lower the sales tax rate to 3.75% for goods and tax all non-exempt services at the same rate. This represents a one percentage point reduction of the sales tax rate.
5. Do not implement taxes on services.

**Figure 1: Policy alternatives, number of new services taxed, and net revenue gain**

	<b>Alternative</b>	<b>Number of services</b>	<b>Estimated revenue gain (million)</b>
1	Tax services taxed in at least 30% of states	33	\$ 778
2	Tax luxury services	12	\$ 69
3	Tax all non-exempt services at 4.75%	105	\$ 2,756
4	Tax all goods and non-exempt services at 3.75%	105	\$ 1,179
5	Do not implement taxes on services	0	\$ 0

Source: Authors' calculations based on 2002 Economic Census data and NC DOR data, 2010