A Sales Tax That Reflects Our Modern Economy

Maryland's sales tax is one of the most important ways we get the resources we need to create thriving communities. Bringing in nearly $5 billion per year, the sales tax funds about 11 percent of the state budget, supporting things like schools, parks, and health care.[i] But our sales tax hasn't been keeping up with economic growth because it is based on outdated principles. As we shift from an economy based on tangible goods to one based on services and as we do an increasing share of our shopping online, the links between our sales tax and our economy get weaker each year. Updating the sales tax will allow us to level the playing field between local retailers and multistate e-commerce giants, apply the same standards to purchases of both goods and services, and strengthen the public investments that make Maryland a great place to live.

Applying Equal Standards to Online Sales

Thanks to a recent Supreme Court decision, Maryland has an opportunity to recover hundreds of millions of dollars in sales taxes that were always owed, but which many online retailers have long avoided collecting. Previously, retailers were only required to collect sales taxes for states in which they had some kind of "physical presence," such as a brick-and-mortar store or an office. This standard made sense for an economy in which most everyday purchases occurred in person, but it now hands an unfair advantage to big e-commerce companies like eBay and Overstock.com that generally aren't required to collect sales tax. In a recent case, the Supreme Court ruled that states can now require online retailers to collect sales taxes, provided that their tax codes satisfy certain standards.[ii] A thoughtful response to the Supreme Court's decision will enable Maryland to invest more in our communities and the pillars of a modern economy.

Here's what the decision means for Maryland:

- **The state could see significant revenue gains.** The U.S. Government Accountability Office estimates that Maryland could bring in up to $252 million per year by requiring online retailers without a physical presence in Maryland to collect sales taxes,[iii] and estimates by the state Department of Legislative Services are even higher.[iv]
- **Policymakers should clarify that only major retailers are required to collect sales tax.** The Court made clear in its ruling that one reason South Dakota's requirement that online retailers collect sales tax was permissible is the relative simplicity of the state's tax. This implies that states could still run into legal challenges if their taxes create too many administrative hurdles for out-of-state vendors. Exempting the smallest sellers—who may make only a few sales into Maryland in a given year—is a relatively inexpensive way to avoid this risk. Past legislative efforts to collect sales taxes from online retailers have already included this exemption.

- **The state should consider joining the Streamlined Sales and Use Tax Agreement.** This agreement encodes several common principles meant to simplify the administration of sales taxes for companies that do business in multiple states.[v] Because Maryland does not have local sales taxes, it is already in line with most of the agreement's requirements. While the Supreme Court did not require states to join the agreement, doing so would provide an additional layer of protection in the event of a legal challenge. Joining the agreement would require changing some features of our tax code and may modestly reduce the revenue gain from taxing online purchases.

Applying Equal Standards to Both Goods and Services

Maryland's economy has changed a lot over the past several decades, but our tax code hasn't kept up. Services increased from less than one-third of household consumption nationwide in 1970 to nearly half as of 2011.[vi] Financial services alone are twice as large as a share of the national economy today as they were in 1970.[vii] But we still exempt most services from the state sales tax, a relic from 20th century tax policy. This double standard doesn't make sense in today's economy. For example, if you bought an album on CD in 1998, you would have paid sales tax. If you purchased the same album in 2018 as a digital download—technically considered a service—you would not pay any taxes. Because of situations like this, our sales tax has grown more slowly than our overall economy.[viii] By broadening the sales tax base to include most services, we can apply the same standard to all purchases and bring our tax code into the 21st century. A bill to tax services introduced in 2012 would have brought in more than $600 million per year once fully implemented, according to the state Department of Legislative Services.[ix]

Three principles will help us construct a smart, modern sales tax:[x]

- **Stable revenues rest on a broad base.** Our sales tax has weakened over time because we excluded a large and growing share of the economy from the tax base. This history should teach us a simple lesson: Stable revenues require a broad tax base free from arbitrary carve-outs. To accomplish this, policymakers should write any legislation to reform our sales tax in such a way that services are assumed to be taxable unless they are explicitly exempted. And exemptions should be rare, to prevent powerful special interests from inserting loopholes for their own benefit.
- **Policymakers should anticipate changes in the economy.** The comprehensive approach outlined above—in which services are assumed to be taxable unless they are explicitly exempted—has an additional benefit. Technological change is by nature unpredictable, which means that any list of specific taxable services written today is likely to be out of date by tomorrow. For example, if policymakers in 1995 had broadened the sales tax base to include services, legislation that relied on a list of specific taxable services would have rightly included things like car repairs and tax preparation, but might have left out things like digital downloads that didn't become widespread until later. In the comprehensive approach, the tax base automatically updates to match the economy. For the sake of clarity, it is reasonable to supplement this comprehensive approach with an enumerated list of services presumed to be taxable—as long as it is equally clear that taxable services are not limited to those on the list.
- **Prudent exemptions have their place.** While policymakers should steer clear of arbitrary exemptions designed to benefit special interests, two kinds of service should not be subject to taxation. First, we should

exempt necessary services just as we currently exempt necessary goods like groceries. Specifically, policymakers should exclude medical care as well as tuition and other nonprofit educational services from the sales tax. Second, policymakers should exempt services that are purchased exclusively by businesses, such as payroll processing and commercial real estate management.[xi] This exemption would prevent so-called "pyramiding" in which businesses pass these taxes through to customers in the form of higher prices. This exemption is especially important for products with a complex supply chain, for which the final purchase price could include multiple levels of sales tax from each point in the production process. Services that are purchased by both businesses and households, like legal services, should still be taxed. The state should not try to exempt business purchases on a case-by-case basis, an approach that would be administratively complex and vulnerable to evasion.

Building a Balanced Sales Tax

While sales taxes are an important source of revenue in Maryland, they place a greater responsibility on families that live paycheck to paycheck than on wealthy individuals who are able to save or invest more of their income. For this reason, at the same time that we modernize our sales tax, we should also ensure that we don't make it harder for families to make ends meet.

Here are some steps policymakers should take:

- **Expand tax credits for working families.** We can use part of the revenue from modernizing our sales tax to expand existing tax credits for working families like the Earned Income Tax Credit or create a new credit specifically linked to sales taxes. This will ensure that low-income families don't take too big of a hit when they purchase newly taxable services like car repairs.
- **Don't tax necessities.** Like many other states, Maryland currently mitigates the impact of sales taxes on low-income families by exempting certain purchases the state considers necessities, like groceries. We should expand this exemption to cover a wider range of essential purchases, such as diapers and personal hygiene products.
- **Create a more balanced sales tax.** Our sales tax currently makes no distinction between everyday purchases like clothing and high-end items purchased exclusively by the wealthy. In fact, some high-end purchases like luxury yachts are taxed at a lower rate than other items.[xii] Creating a graduated rate scale or luxury surtax would allow us to collect more revenue without placing greater responsibilities on low-income families. For example, a 1 percent surtax on purchases over $10,000 (with a higher threshold for cars) could bring in substantial revenue from individuals who currently pay only a miniscule portion of their income in sales taxes.[xiii]

[i] "Budget Highlights: Fiscal Year 2019," Maryland Department of Budget and Management, 2018, http://dbm.maryland.gov/budget/Documents/operbudget/2019/Proposed/BudgetHighlights.pdf

[ii] Adam Liptak, Ben Casselman, and Julie Creswel, "Supreme Court Widens Reach of Sales Tax for Online Retailers," *The New York Times*, June 21, 2018, https://www.nytimes.com/2018/06/21/us/politics/supreme-court-sales-taxes-internet-merchants.html

[iii] "Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs," U.S. Government Accountability Office, 2017, https://www.gao.gov/assets/690/688437.pdf

[iv] Michael Sanelli, "Fiscal and Policy Note: House Bill 1213," Maryland Department of Legislative Services, 2017, http://mgaleg.maryland.gov/2017RS/fnotes/bil_0003/hb1213.pdf

[v] See the Streamlines Sales Tax Governing Board, http://www.streamlinedsalestax.org/

[vi] Michael Leachman and Michael Mazerov, "Four Steps to Moving State Sales Taxes into the 21st Century," Center on Budget and Policy Priorities, 2013, https://www.cbpp.org/research/state-budget-and-tax/four-steps-to-moving-state-sales-taxes-into-the-21st-century

[vii] MDCEP analysis of Bureau of Economic Analysis personal consumption expenditures data.

[viii] The effective sales tax base (revenues divided by the statutory tax rate) declined from 29 percent of Maryland personal income in 1980 to 21 percent in 2017 (MDCEP analysis of revenue data from the Maryland Department of Legislative Services and Department of Management and Budget and personal income data from the U.S. Bureau of Economic Analysis).

[ix] Michael Sanelli, "Fiscal and Policy Note: House Bill 1051," Maryland Department of Legislative Services, 2012, http://mgaleg.maryland.gov/2012rs/fnotes/bil_0001/hb1051.pdf

[x] For detailed discussion of these principles, see Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, 2009, https://www.cbpp.org/research/state-budget-and-tax/expanding-sales-taxation-of-services-options-and-issues

[xi] Some policymakers may be concerned that such exemptions would allow large corporations to avoid their responsibility to contribute to the cost of public investments we all rely on. This is a legitimate concern. The best way to ensure that businesses are pulling their weight is to strengthen the corporate income tax. This approach does not create the same pyramiding concerns because businesses are allowed to deduct the cost of production inputs.

[xii] See Maryland Code, Natural Resources Article §8-716 (http://mgaleg.maryland.gov/webmga/frmStatutesText.aspx?article=gnr&section=8-716&ext=html&session=2019RS&tab=subject5). Boats are generally subject to a 5 percent excise tax instead of the state's 6 percent sales tax.

[xiii] See for example House Bill 1162 of 2013, which would have imposed a 1 percent surtax on purchases over $8,000, with a $50,000 threshold for vehicles (http://mgaleg.maryland.gov/webmga/frmMain.aspx?id=hb1162&stab=01&pid=billpage&tab=subject3&ys=2013rs).