COST
COUNCIL ON STATE TAXATION

Sales Taxation of Business Inputs

Policy Position

Position: *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.*

Explanation: A sales tax on business inputs violates several tax policy principles—economic growth, equity, simplicity and efficiency—and causes a number of economic distortions. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced to either pass these increased costs on to consumers or reduce their economic activity in the State in order to remain competitive with other producers who do not bear the burden of such taxes. As a result of the choices businesses are forced to make, 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).

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. Proposals to extend the sales tax to business services further exacerbate the adverse economic distortions from the current taxation of business purchases. For example:[1]

- 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;

- 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; and,

- 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.

[1] A thorough discussion of the problems associated with the taxation of business inputs, including services purchased by business, can be found in the study prepared for COST by Ernst & Young LLP, *"What's Wrong with Taxing Business Services? Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services"* (www.cost.org).

122 C Street, N.W., Suite 330 ● Washington, DC 20001-2109 ● Tel: 202/484-5222 ● Fax: 202/484-5229