The Challenge of Taxing Services

TAX & FISCAL FACTS

At Issue

Every few years, there are renewed discussions of imposing a sales tax on services in California, often proposed in the name of "modernizing the economy," closing California's budget gap, or stabilizing cyclical fluctuations in tax revenue. Recently, the discussion has been precipitated by talk of "tax reform" and options to increase revenue.

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While medical services most likely would be exempt from a sales tax on services, some health-related costs could be subject to tax.

What services could be subject to tax?

Currently, California individuals and businesses pay taxes on the purchase or use of various tangible goods, but do not pay taxes on services. Past legislative proposals have varied in the specific services that would be subject to tax; however, most would tax everyday services including:

- Grooming (haircuts, manicures, spa services)
- Child care and babysitting
- Dental cleanings, fillings and braces
- Home phone and cell phone service
- Cable and satellite television
- Music lessons, dance lessons and golf instruction
- Admission tickets to movies, sporting events and amusement parks
- Access to golf facilities and ski resorts
- Shipping and delivery of packages
- Installation services for flooring, windows and appliances
- Repair and maintenance of cars, homes and appliances
- Lawn and pool maintenance and cleaning
- Tax preparation and advice
- Attorney services for divorce proceedings, child custody and criminal cases
- Veterinary services and pet grooming
- Car rentals and storage unit rentals
- Home alarm/security service
- Tips at restaurants
- And many more...

Under most proposals to impose a service tax, services used by businesses would be taxed if they are out-sourced and not provided in-house. Some examples:

- Accounting and payroll
- Legal and attorney services
- Research and development
- Architectural design and construction
- Product design and engineering
- Consulting
- Manufacturing
- Advertising
- Procurement, transportation and shipping/ delivery
- Equipment installation
- Repair and maintenance
- Telecommunications and cellular service
- Security
- And many more...

The State Board of Equalization reported in 2015 that Californians would pay $122 billion per year in higher taxes if the retail sales tax were imposed on all services that currently are untaxed.

Would a sales tax on services "modernize" the tax system and promote economic growth?

Proponents of a sales tax on services often seek to raise tax revenue and "modernize the economy," because, in their opinion, there has been a shift from the consumption of goods to a consumption of services. There are several reasons why this premise is flawed, and why a sales tax on services would prove harmful to the state's long-term economy.

First, while the economy in general has moved from manufacturing to service industries from an employment perspective, from a taxable consumption perspective, there is simply no conclusive evidence that consumption of services has outpaced the consumption of goods. To the degree that taxable sales have declined as a percentage of personal income, it could be explained by several reasons: (1) greater consumption of goods that currently are exempt from taxes, such as food, prescription medicines, etc.; (2) higher consumption of various services that the Legislature likely will exempt from a sales tax, such as medical care and education; and (3) the decline in prices of goods due to lower production costs overseas.

Second, taxed activities tend to grow slower than untaxed activities. If California's economic future depends on the production of high value-added services, taxing those services merely serves to slow economic growth. A tax on labor, at a time when California's unemployment rate remains high and the state's recovery is tenuous, would be a significant setback to regaining the jobs lost during the last several years.

While broadening the sales tax to services would bring some amount of new revenue to the state in the short term, it could stifle long-term economic development. For example, taxing services would lead to a migration of not only service jobs and businesses out of state, but also the jobs and businesses that either support or are end-users of those taxed services. A tax on services also would be a deterrent to business expansion or relocation in the state. All other factors being relatively equal, business expansion and relocation decisions typically are predicated on factors that maximize returns on investment – and a sales tax on services would mean lost investment and employment opportunities.

Migration of businesses and jobs would not only hurt workers, but also would lower corporate tax and personal income tax revenue for the state. Additionally, fewer higher-paying jobs means less homeownership, which reduces property tax values and revenue. And fewer jobs means less disposable income for purchases of goods that support the sales tax revenue base. All of these situations limit economic growth for the state over the long run.

What problems are associated with taxing business-to-business sales?

Economists and tax experts generally recommend against imposing a service tax on business-to-business sales, or "business inputs," for a variety of reasons.

First, a service tax puts in-state businesses at a competitive disadvantage, because it increases the cost to produce or provide a good or service. For some businesses, this increase may lead to higher prices, creating pricing disadvantages for California goods and potentially reducing demand. This would result in lower product sales and decreased manufacturing in the state. Other businesses may be unable to pass along the cost, because they compete in the national and international markets. These businesses would be

Building, construction, repair and other maintenance or repair services could be subject to a sales tax on services.

inclined to reduce investment and employment in the state to compensate for the higher costs, resulting in fewer jobs and opportunities for economic growth.

These competitive disadvantages would extend to in-state businesses that contract for services vs. those with in-house staff; between businesses of different sizes; and between private service providers vs. federal providers. For example, businesses that procure services would be subject to the tax, while competitors with in-house staff would not. Smaller businesses, which tend to outsource their accounting, repair, maintenance, payroll, etc., would be disproportionately impacted because they would pay taxes on these services, while larger competitors that employ in-house staff, and may already benefit from other economies of scale, would not. Additionally, a service tax sometimes favors federal service providers, such as the U.S. Postal Service (which would not be subject to tax under the U.S. Constitution's Supremacy Clause) over private providers like FedEx or UPS, which would be taxed.

A service tax on business inputs also poses significant administrative, auditing and compliance challenges for both the state and taxpayers, because it would be difficult (especially for multi-state businesses) to determine where a service is consumed. Costs for the state to administer select services have been estimated at upward of several hundred million dollars a year, not including compliance costs for taxpayers.

Pet grooming and veterinary services could be subject to a sales tax on services.

Finally, from an economic and tax policy perspective, a tax on services leads to "tax pyramiding" – taxing an input as it moves through the various stages of production, and taxing it again when purchased by a consumer. This not only reduces tax transparency, but also causes distortion, making it impossible for policymakers to determine the final effects of the tax on the consumer.

What impact will a service tax have on California's businesses, families and economy?

A broad-based tax on services would expose the state to numerous adverse economic consequences:

- **Puts California businesses at a competitive disadvantage.** California has the highest state sales tax rate in the nation, and the highest top personal income tax rate compared to other states.[1] A sales tax on services would make it even harder for California companies to compete, on several levels. For example, California service industries would have a significant pricing disadvantage compared to services provided in other states. Not only would this reduce demand for California-based services, it also would make it more costly for California companies that use taxable services to produce or provide goods and services. California products/services would be more expensive and, all other factors being equivalent, would have less demand than their out-of-state counterparts. A tax on services would threaten many of California's key industries, including high-tech, manufacturing, and the financial sector.

- **Reduces jobs and investment in the state.** Lower demand for a product or service often forces businesses to cut

Business services, such as architectural, interior design, graphic design, printing, accounting, legal, etc., could be subject to a sales tax on services.

operational costs through layoffs and reduced investments. Other businesses may be forced to move their operations to lower-cost states to remain competitive. Both scenarios reduce opportunities for job and economic growth in California.

- **Puts small businesses at risk, potentially drives them underground.** Higher taxes on certain services could lead to a do-it-yourself approach. For example, if a tax were imposed on pool cleaning services, some taxpayers may opt to do the work themselves rather than pay the increased cost. This could put many small businesses and their employees out of work. Additionally, it could drive others to move their operations into the underground economy, putting law-abiding service businesses at an unfair disadvantage. Both of these situations would reduce tax revenue to the state's general fund.

- **Discriminates against small businesses.** Larger businesses that can afford to hire employees to do the work of an independent contractor would not pay sales taxes on services performed by these employees. Smaller businesses, however, would be forced to pay sales tax, as they must contract for these services. This results in higher costs on small businesses.

- **Hurts working families and disadvantaged communities.** Expanding the sales and use tax to services creates a more regressive tax base, because the tax requires working families and disadvantaged communities to pay a larger portion of their income than higher-income taxpayers for service-related taxes. The California Budget Project notes that "extending the sales tax to services is unlikely to improve the equity of the sales tax."[2] Repair services are particularly integral to budgets of families who cannot afford to purchase a new appliance, car or home. Costly taxes would have to be paid on services to repair leaky pipes, replace a roof, or perform any other needed maintenance and repair. This runs counter to the basic policy principle that taxes should be based on an individual's ability to pay.

- **Increases costs to government.** Unlike many states, California taxes sales made to and by state and local governments. Government entities, including school districts, are huge consumers of services, and

Transportation and movement of goods could be subject to a sales tax on services.

would incur cost increases of 7.5 percent to 10 percent on taxed services they purchase. Moreover, government is a huge seller of services relating to everything from education (colleges and universities) to housing (low-income housing authorities) to medical care (public hospitals). Thus, taxing services shifts a significant portion of the sales tax burden to government, thereby increasing the cost of government for taxpayers and those who consume services sold by the government (i.e., increasing tuition on college students).

- **Picks winners and losers.** Past proposals have sought to tax some industries, while exempting others. Good public policy dictates that taxes be imposed in a manner that promotes market neutrality, and does not competitively disadvantage one industry or group of taxpayers to the benefit of another. A service tax runs counter to the principles of sound tax policy. It exacerbates competitive disadvantages among in-state businesses, puts California businesses at a competitive disadvantage relative to out-of-state businesses, and sometimes tips the scale in favor of the federal government over California companies. These types of proposals create winners and losers, and benefit one industry or business to the detriment of another.

- **Creates costly and extensive administrative problems.** Imposing a sales tax on services would lead to extensive administrative problems. The State Board of Equalization (BOE) would have to identify and register myriad new businesses, many of which are unfamiliar with sales and use tax reporting and remittance requirements. The BOE potentially would have to register teenagers who provide babysitting services, mow lawns, or tutor students.

  The agency also would need to develop a new method for auditing service providers, which will prove difficult, because BOE staff would have to determine where a particular service was used or consumed, if doing so is even possible. For example, at what point would the service be taxed if computer software development/consulting services are contracted in one state, performed in a second state, delivered to clients in a third state, and distributed by the client to business locations in additional states?

  A BOE analysis of a 2011-12 sales tax on services proposal (AB 1963 – Huber) estimated state administrative costs in the neighborhood of $847 million in the first year and more than $600 million annually thereafter.[3]

Past and current legislative proposals to assess sales tax on services

Over the past two decades, there have been sporadic attempts to impose sales tax on services in California. In 1995-96, AB 194 (K. Murray) proposed to tax a number of specified services, including general repair of tangible personal property, installation of tangible personal property, and computer programming. In 2005-06, AB 9 (Coto) proposed to impose a tax on the gross receipts derived from specialized services, as defined. Both measures failed in the policy committee.

As part of the 2009-10 budget process, draft language proposed to enact a sales tax on a number of specific services, including veterinary care and admission to sporting events. However, the proposal never made it into a bill. More recently, two measures were introduced in 2011-12 proposing a sales tax on services – the previously mentioned AB 1963 (Huber), and AB 2540 (Gatto). AB 1963 proposed a broad sales tax on services (with a limited number of services exempted), along with a reduction in the personal income tax and the sales and use tax rates. AB 2540 proposed to tax specifically enumerated services. Both measures subsequently were amended to remove provisions that would enact a sales tax on services.

SB 8 (Hertzberg), introduced in the 2015-16 legislative session, proposed a sales and excise tax on services at an unspecified rate, beginning on January 1 of an unspecified year. The sales tax would be imposed on sellers of taxable services. The excise tax would be imposed on buyers of services. Both taxes would be imposed independently of each other, and are expected by proponents to raise taxes by $10 billion a year. The measure also intended to reduce the personal income tax for low-income earners, while “evaluating” the current corporate tax rate along with an increase in the state’s minimum wage. While the implementing language provided no exemption from either tax, legislative findings and declaratory language elsewhere in the bill intended to exclude health care services, education services, and small businesses with gross sales of less than $100,000 a year.

The debate over expanding the retail sales tax to services has been pervasive in talks of “tax reform” and is expected to be ongoing.

Experience from other states

Although many states tax some services, there is no apparent trend toward expanding the sales tax base to include more services. According to the Federation of Tax Administrators (FTA), other states have been reluctant to undertake a broad-based expansion of the sales tax base since several states have repealed such expansions shortly after enactment. Only two states – Hawaii and New Mexico – have broad-based sales taxes on services, while South Dakota and West Virginia are the only other states to tax more than 100 services.[4]

Four states repealed sales taxes on services shortly after enactment:

After-school programs, tutoring, restaurant tips, and automotive repair services could be subject to a sales tax on services.

- **Florida.** Hailed as a way to meet the expanding fiscal needs of this fast-growing state, the Florida services tax was expected to bring in $1.3 billion annually. Florida enacted its services tax in July 1987 and repealed it six months later because it put in-state businesses at a competitive disadvantage with out-of-state counterparts.

- **Massachusetts.** With legislation enacted in 1990, Massachusetts attempted to tax only services provided to businesses. These included legal services, accounting, auditing, bookkeeping, engineering and architectural services. The tax would have created competitive disadvantages for service providers located within Massachusetts, but the state repealed the tax two days after it took effect.

- **Maryland.** In 2007, the Maryland Legislature enacted a computer services tax, covering web design, facilities management, custom computer programming, data center support, systems integration, installation and maintenance, computer training and data entry. According to the Maryland Computer Services Association, the tax would have been "a serious blow" to Maryland IT businesses, which at the time employed 68,000 people with an annual payroll of $5.2 billion. The tax was repealed in 2008, before it went into effect.

- **Michigan.** The Michigan Legislature enacted a 6 percent tax on services in October 2007. This tax was imposed on business service center services, consulting and investment advice, janitorial services, landscaping, warehousing, packaging, procurement, and personal services. Before the tax became effective, taxpayers formed a coalition to repeal it, arguing that it would hurt Michigan's economy and force jobs to leave the state. The tax was repealed just 17 hours after its effective date.

Conclusion

While imposing a sales tax on services would bring in some additional short-term revenue to the state, it would stifle the state's economic growth in the long term. California businesses would be put at a competitive disadvantage, because goods produced in-state would be less price-competitive compared to their out-of-state counterparts. Jobs and investment opportunities would be lost as employers seek to relocate or expand in lower-cost states. Small businesses and working families would be disproportionately affected. And costs to administer a broad-based proposal are estimated to be in the hundreds of millions of dollars a year.

Endnotes

1 The Tax Foundation, *State and Local Sales Tax Rates,* Midyear 2014.
2 California Budget Project, *Should California Extend the Sales Tax to Services?*, 2011.
3 State Board of Equalization, Draft Staff Legislative Bill Analysis of AB 1963 (Huber), 2012.
4 Federation of Tax Administrators, *FTA Survey of Services Taxation – Update, 2008.*

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