CALIFORNIA BUDGET PROJECT

BUDGET BACKGROUNDER

OCTOBER 2011

MAKING DOLLARS MAKE SENSE

SHOULD CALIFORNIA EXTEND THE SALES TAX TO SERVICES?

Extending the state's sales tax, which currently applies almost exclusively to goods, to services is often discussed as a way to help balance the budget and modernize California's tax system. Expansion of the sales tax base – the range of purchases subject to tax – could raise significant new revenues, as well as improve the stability of the tax and improve its economic neutrality by removing the current system's preference for purchases of services over goods. There are also issues that should be considered to minimize adverse economic consequences and prevent a shift in the share of overall public revenues paid by high-income Californians to lower- and middle-income Californians. This *Budget Backgrounder* explores the arguments for and against taxing services, examines how much might be raised from taxing various services, and explores who pays the sales tax and whether that would change under an expanded sales tax base.

History of the Sales Tax

California's sales tax law, like that of most other states, reflects its origins in the early 1930s. First imposed in 1933, the tax applies almost exclusively to the sale or use of tangible goods. Initially, the state sales tax exempted only utility service and gold bullion. An exemption for food was added two years later in 1935. Two reasons appear responsible for the minimal consideration given to the taxation of services. First, services accounted for a smaller share of economic activity during the 1930s. In 1933, for example, goods accounted for 52 percent of consumer expenditures, with services accounting for 48 percent. By 2010, services' share of consumption had risen to 67 percent – double the 33 percent share for goods. Secondly, at the height of the Great Depression, policymakers feared taxing services, viewing it as a tax on labor that would discourage employment. Only New Mexico, which still taxes a larger number of services relative to other states, initially imposed a tax that treated the sale of goods and services equally.

Sales Tax Revenues Have Declined as a Share of the Economy

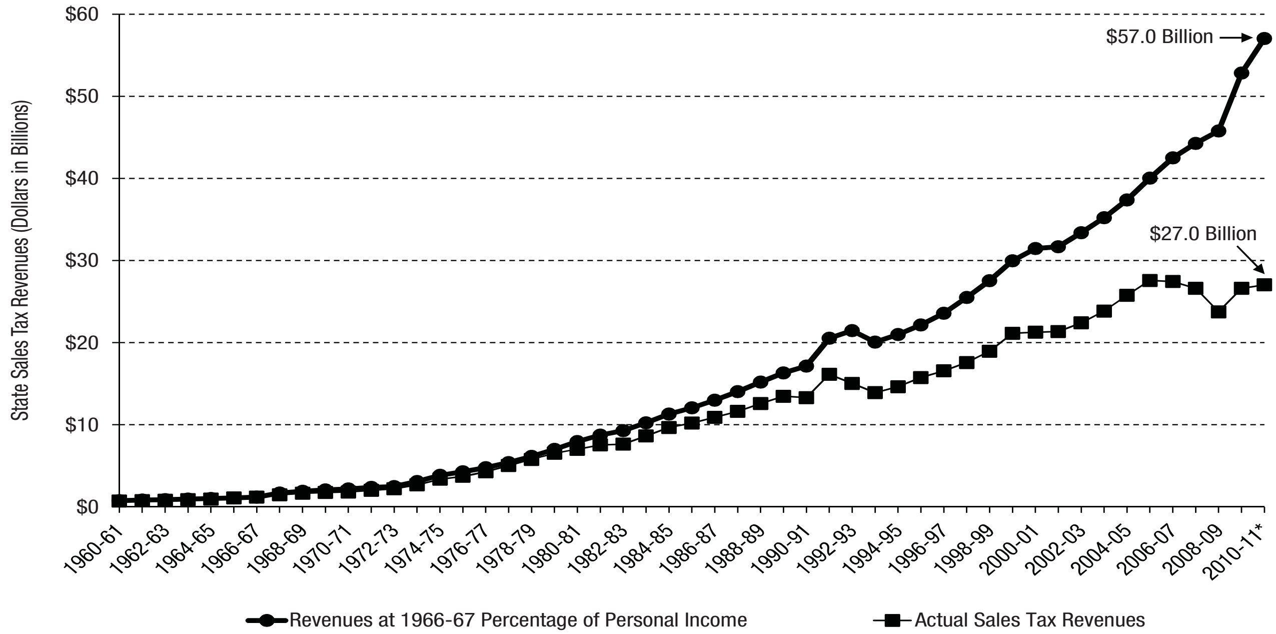
California's sales tax law stayed stagnant in the face of the broader changes in the economy. Over time, this led to an increase in the share of consumer purchases that were not subject to the sales tax and a reduction in sales tax revenues as a share of consumption expenditures. If sales tax revenues accounted for the same share of the state's economy today as they did in 1966-67, state revenues would be $30 billion higher in 2010-11 – slightly less than combined annual spending for all health and human services programs, community colleges, the California State University system, and the University of California. (Figure 1).

The downward slide of sales tax revenues as a share of the economy was exacerbated by policy choices. When confronted with specific choices, policymakers have tended to narrow the base of the tax by exempting goods that resembled services from taxation, such as custom software, rather than taxing services that fulfill purposes similar to those of goods. California currently lags behind most states in the number of services taxed. In fact, only services closely tied to property – such as tuxedo rental and sign construction – are subject to the sales tax.[1] A 2007 survey by the national Federation of Tax Administrators found that California taxed only 21 of 168 identified services.[2] Only nine states taxed fewer services.

How Could Services Be Taxed?

Most discussions of taxing services focus on one of three approaches: extending the existing sales tax to all services, taxing a select number of services, or imposing a broad-based tax at a low rate on businesses' gross receipts from the sale of services.

Figure 1: State Sales Tax Revenues Would Be $30 Billion Higher if Taxable Sales Had Remained at 1966-67 Levels as a Share of the Economy



* Estimated
Source: CBP analysis of Department of Finance, Legislative Analyst's Office, and US Bureau of Economic Analysis data

Of the three methods, extending the existing sales tax to all services would maximize revenue collections, but would raise significant economic and administrative concerns and generate the most opposition. Pyramiding could be minimized by a "sale-for-resale" exemption similar to that provided for goods under the current law. This, however, would also reduce the amount of revenues raised and result in households, rather than businesses, paying a larger share of the tax. A very broad tax that included services that could easily be purchased from out-of-state retailers might also be difficult to collect. While some services are ill suited to sale on-line – such as car repair or haircuts – collecting sales taxes owed on services purchased from out-of-state sellers would face the same problems as presented by electronic sales of goods under the state's current goods-based sales tax.[3]

A selective approach could minimize administrative considerations and economic problems through the choice of which services would be subject to the tax. Targeting services that are geographically tied to consumers, such as auto repair, janitorial services, or dry cleaning, would eliminate the necessity for complex apportionment schemes and would avoid the problem of trying to collect taxes owed on purchases made from out-of-state sellers. However, to the extent that the resulting tax emphasized personal over business services, individuals and particularly lower-income households would potentially pay a greater share of the tax.

A third option would be a broad-based tax on services at a very low rate. Keeping the rate low and imposing the tax on gross receipts with no or few exemptions could minimize concerns over pyramiding and collecting amounts due from out-of-state sellers, on the one hand, since at a low rate, the tax would account for a smaller share of the total cost of services purchased. A low-rate tax would, however, require creation of a new tax administration system and could increase complexity for merchants that sell both goods and services.

What Services Should or Could Be Taxed?

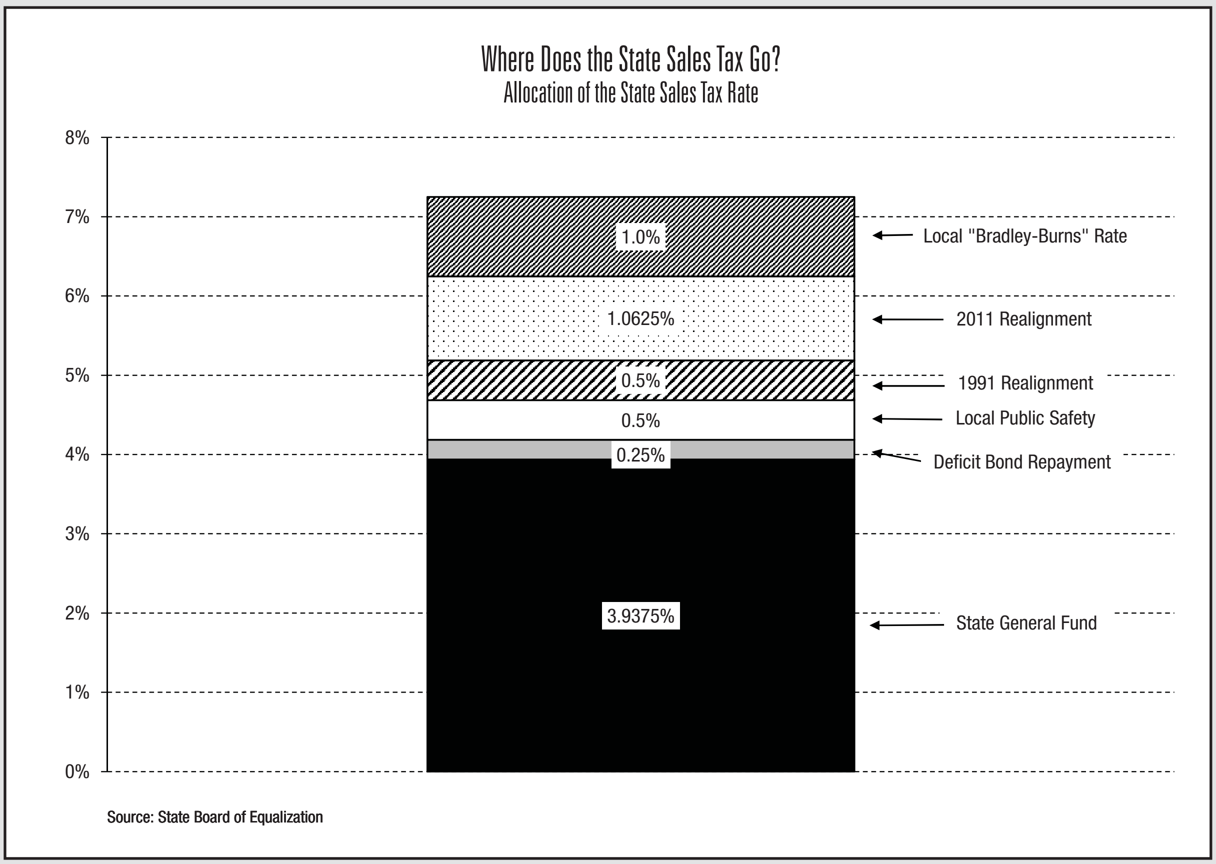
Most experts argue that the general policies that apply to taxing goods should also apply to imposing the sales tax on services. California currently exempts food for home consumption and prescription drugs, deeming them necessities, and exempts purchases that will be resold to consumers in order to avoid multiple taxation of the same item. These principles argue for exempting essential services, such as health care, education, and child care as well as services that are immediately resold at retail.

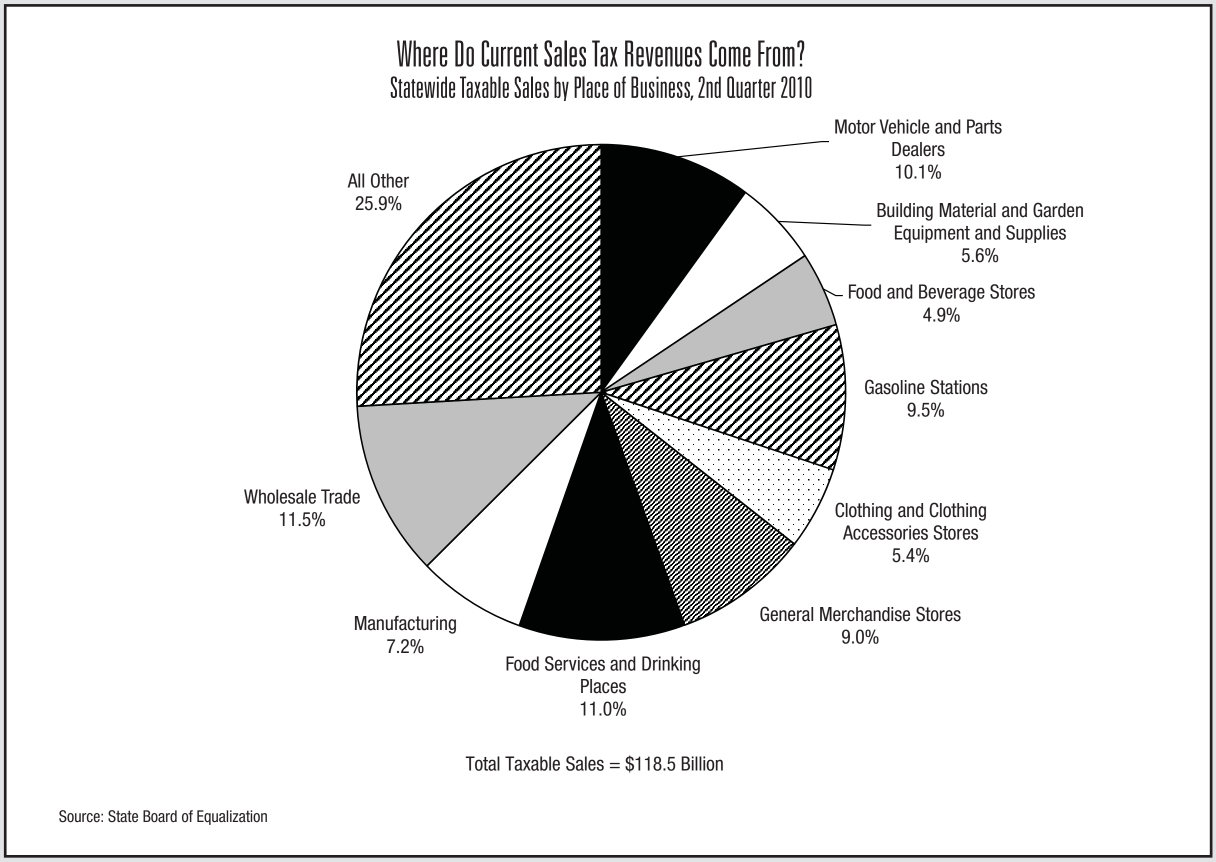
Economists generally argue that the sales tax should not be imposed on "business-to-business" services for several reasons. First, the sales tax is designed to tax consumption by the ultimate user of a good or service. To tax purchases that become part of a final product, they argue, leads to "pyramiding," which occurs when the price – including the tax – of inputs used to produce the product are subject to tax when a business sells the product incorporating the previously taxed goods or services. They also note that taxing business services may discriminate against small businesses that, for example, are less likely to employ in-house lawyers or accountants and more likely to purchase services from other businesses.

How Does the Sales Tax Work?

California's sales and use tax, like those of other states, is a tax on the purchase or use of goods and services within the state. The tax is imposed at a specified rate, expressed as a percentage of the purchase price. California's statewide rate is 7.25 percent.[4] Of that rate, revenues from a rate of 3.9375 percent are deposited in the state's General Fund, and the remainder is allocated to a number of specific purposes. State law also authorizes counties, some cities, and some special districts to impose "add-on" rates with voter approval. These taxes apply to the same purchases as the statewide tax. The total sales tax rate ranges from 7.25 percent in jurisdictions with no add-on rates to 9.75 percent in the City of Pico Rivera in Los Angeles County. Gas stations, food services and drinking places, and automotive dealers and auto part sellers account for the largest share of current state sales tax collections, with each accounting for about 10 percent of total tax collections.

In 2010-11, the state's portion of the sales tax – which includes the revenues deposited in the General Fund, the Local Revenue Fund to support programs transferred to counties in 1991, and the rate used to repay outstanding deficit bonds – raised $30.6 billion. The sales tax accounts for the second-largest share of state revenues, surpassed only by the personal income tax. Each 0.25 percent increment of the sales tax generated $1.2 billion in 2010-11.



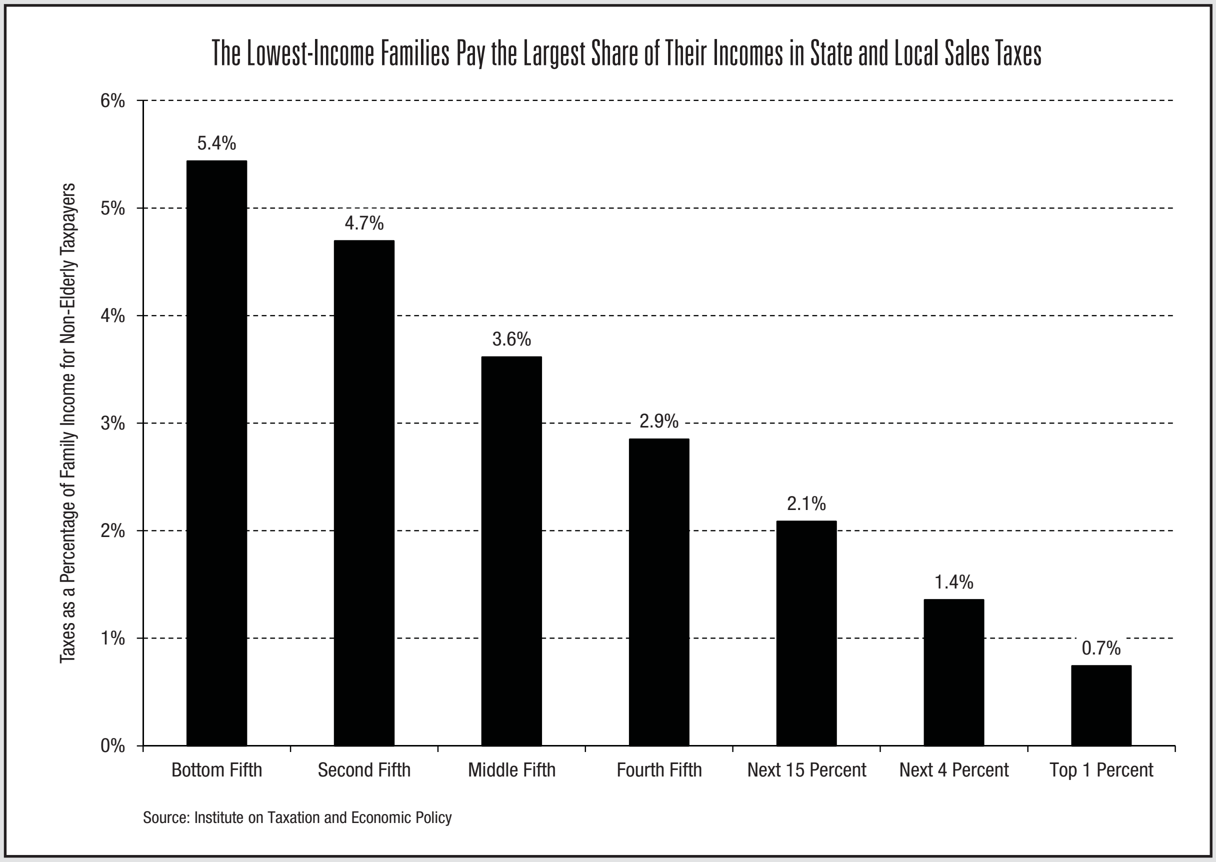


For most purchases, the retailer adds the sales tax onto the purchase price, collects the tax from consumers, and remits the tax to the state Board of Equalization, which administers the tax. Under California's "use tax" law, purchasers of goods from out-of-state retailers are responsible for paying taxes owed directly to the state.[5] The use tax also applies to certain other transactions, such as the purchase of used cars from a private individual, where the seller does not collect the tax at the time of purchase. All states that have a sales tax also have a use tax to ensure that residents do not purchase goods out-of-state to avoid the state tax.

California's sales tax is a classically regressive tax. Lower-income households pay a larger share of their incomes in sales tax than do higher-income households. Taken as a whole, Californians pay a moderate share of their income in sales tax. In 2007-08, the state ranked 22nd among the 50 states with respect to sales taxes as a share of personal income. California's relative position among the state reflects a statewide tax rate of 7.25 percent that is the highest rate in the nation, combined with a relatively narrow sales tax base.[6]

Others argue that the problems with taxing business-to-business services are often exaggerated. Moreover, while some services are incorporated into a product that will be eventually sold and subject to tax, in other instances the business is the ultimate consumer. A business that purchases landscaping or janitorial services, for example, is the final consumer of that service. These observers would argue for taxing those services that are not incorporated into a product that is sold and subject to tax. This approach is similar to the "sale-for-resale" exemption provided in California's goods-based tax. They would also note that exempting businesses' purchases of services would increase the regressivity of the tax and greatly reduce the amount of revenue collected.

Collecting taxes owed on services purchased from out-of-state retailers raises the same set of issues that apply to purchases of goods. Similar to existing law, purchasers of services from out-of-state vendors would legally owe the tax, but few would likely pay amounts owed absent a requirement for sellers to collect and remit the tax to state authorities. California's recent use tax law would mandate collection beginning January 1, 2013 if Congress passes a law authorizing states to require out-of-state sellers to



Revenues raised from each one percent of the state's sales tax have posted modest growth over time. Between 1970-71 and 2010-11, revenues raised by a one percent sales tax rate rose by 6.1 percent annually, on average. In contrast, state personal income tax revenues averaged a 10.4 percent annual growth rate during the same period, and corporate income taxes increased by 8.8 percent annually, on average. The shift in economic activity from goods to services and the rise of online sales from out-of-state merchants are two major factors contributing to the relatively modest growth in sales tax revenues.

collect state sales and use taxes, or on September 15, 2012 if Congress fails to act on or before July 31, 2012.[7]

Arguments for Extending the Sales Tax to Services

Proponents of extending the sales tax to services argue based both on economic policy considerations and on the attractiveness of raising additional revenues for cash-strapped state and local government coffers. Specific arguments in favor of taxing services include:

- **Raising revenues.** Extending the tax at the state's existing tax rate, either comprehensively or selectively, would raise a significant amount of additional revenues that would benefit the state, counties, and cities.[8] Extending the sales tax to services taxed in at least one other industrial state would raise state General Fund revenues by more than $8.7 billion. Extending it to services currently taxed in a large number of states would raise nearly $2.7 billion (Appendix A).[9] To the extent that growth in the service sector outpaces that of taxable goods, revenue growth would also be stronger over time.

- **Improving "horizontal equity."** Economists talk about two types of tax equity. A tax is "horizontally" equitable if it taxes similar economic activity similarly. For example, a horizontally equitable tax would tax all forms of income or consumption at the same rate. "Vertical" equity refers to how a tax affects taxpayers at different income levels. From an economic perspective, the primary argument for taxing services is that it eliminates the preference currently provided for the purchase of services relative to the purchase of goods.

Taxing one type of consumption and not another violates the principle of economic neutrality – that purchases fulfilling similar functions should be treated similarly – and may lead consumers to make different choices than they would in the absence of differential taxation. Exempting auto repair services from the sales tax, for example, reduces the cost of repairing a car relative to the purchase of a new car. Similarly, taxing the purchase of a book or CD while exempting the electronic download of the same book or music provides a preference for one type of purchase of the same material over another. Extending the sales tax to services, including digital downloads, would eliminate that preference.

- **Making the sales tax less volatile.** Taxing services may also make sales tax collections more stable during economic downturns. Analysts note that consumers often defer major purchases – such as automobiles and appliances – when the economy is weak. In contrast, purchases of services, such as auto repair and haircuts, tend to be more stable. Thus, some researchers note that extending the sales tax to services could modestly help stabilize tax collections during tough economic times.[10]

- **Leveling the playing field for land use decisions.** Since the passage of Proposition 13 in 1978, which cut local governments' property tax revenues approximately in half, the sales tax has become increasingly important as a source of local revenues. In recent years, observers note that the "fiscalization" of local land use decisions – a preference for "big box" retailers, auto dealerships, and other sales tax-producing businesses – has led many localities to favor retail development at the expense of manufacturing or residential development. Taxing services would broaden the types of sales tax-producing development and could serve to reduce the often-criticized "cash-box" zoning that now occurs.

Arguments Against Taxing Services

Opponents argue that extending the sales tax would increase the state's reliance on taxes paid disproportionately by lower-income households, while others argue that taxing services would inhibit the sector that is primarily responsible for job growth in the economy. Others cite administrative complexity and the difficulty of collecting taxes on purchases made by California residents from out-of-state merchants as reasons to maintain the status quo. While some concerns can be addressed through the design of the tax and the choice of services to be taxed, challenging issues remain. In some instances, the solution to one problem – such as providing an exemption for services used primarily by businesses to avoid pyramiding – exacerbates other problems such as regressivity. Significant arguments against taxing services include:

- **"Pyramiding" or double taxation.** Critics argue that taxing services will lead to consumers paying taxes upon taxes, often referred to as "pyramiding." Pyramiding occurs when a tax is imposed on goods or services that are incorporated into a final product that is also subject to tax. Interestingly, some research suggests that sales taxes that are built into the cost of goods or services that are ultimately subject to tax may be even more regressive than the sales tax imposed on final purchases.[11] One frequently cited example of pyramiding in the state's current sales tax law is the taxation of manufacturing equipment used to produce goods that are subject to tax when sold. The impact of pyramiding can be minimized by only taxing services sold for ultimate use by consumers, by taxing services at a low rate, or by exempting services that become part of a final product that is subject to tax, similar to the policies that currently apply to tangible goods.

- **Regressivity.** The sales tax is often faulted for being a regressive tax – a tax that accounts for a larger share of the income of low-income households than it does of those with higher incomes. Researchers generally conclude that a "revenue neutral" expansion of the sales tax to a broad range of services may make the sales tax slightly less regressive than the current goods-based tax.[12] However, providing an exemption for services sold primarily to businesses to avoid the problem of pyramiding described above would make extension of the sales tax more regressive, as would taxing services and using the resulting revenues to reduce personal or corporate income taxes.[13] While a careful choice of services can minimize the regressivity of the tax, extending the sales tax to services is unlikely to improve the equity of the sales tax. That is why many observers argue that the most desirable policy would be to extend the range of goods that are taxed – broadening the "base" of the sales tax – while reducing the rate at which both goods and services are taxed.

- **Impact on small businesses.** Critics argue that taxing services purchased by businesses will disproportionately affect small businesses that cannot afford to hire staff to perform services "in house" relative to larger firms that can hire staff to perform legal, accounting, and other necessary services. For example, a business that employs lawyers to provide legal services would not pay the tax, while those that use outside attorneys would pay the tax. While this argument can be addressed by exempting services purchased by businesses, the result would be to increase the share of the tax paid by households relative to businesses and to add complexity to tax administration.

Conclusion

Extending California's sales tax to services could improve the equity of the tax by removing the current preference for consumption of services over goods. Absent a reduction in the state's sales tax rate or other efforts to minimize the regressive impact of taxing services, extension of the tax would increase the share of taxes paid by low- to middle-income Californians, who already pay the largest share of their income toward taxes, relative to high-income households.[14]

Jean Ross prepared this Budget Backgrounder. *The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

1 Federation of Tax Administrators, *2007 Services Taxation Survey,* downloaded from http://www.taxadmin.org/fta/pub/services/online/default_07.html on September 21, 2011.

2 Federation of Tax Administrators, *FTA Survey of Services Taxation - Update* (July 2008), downloaded from http://www.taxadmin.org/fta/pub/services/btn/0708.html on June 21, 2011.

3 See California Budget Project, *Narrowing the Gap: Options for Boosting California's Sales Tax Collections From Online Retailers* (April 2011) for a discussion of issues related to the taxation of purchases made from out-of-state retailers.

4 Many counties, some cities, and some special purpose districts, such as transit districts, impose additional "add-on" rates.

5 See California Budget Project, *Narrowing the Gap: Options for Boosting California's Sales Tax Collections From Online Retailers* (April 2011) for a discussion of issues related to the taxation of purchases made from out-of-state retailers.

6 Federation of Tax Administrators, *State Sales Tax Rates and Vendor Discounts* (February 2011). The base of a tax refers to the range of items or activities that are taxed. As noted above, California taxes relatively few services. The state also exempts food and other necessities that are taxed in many states.

7 AB 155 (Calderon and Skinner, Chapter 313 of 2011).

8 Transit and other districts levying special sales tax rates would also receive additional revenues.

9 Letter from Judy Chu, Chair, California Board of Equalization to Honorable Don Perata, et al., (April 21, 2008). Cities, counties, and other jurisdictions imposing sales tax rates, such as transit districts, would also receive increased revenues.

10 Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues* (Center on Budget and Policy Priorities: July 2009), p. 15.

11 Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues* (Center on Budget and Policy Priorities: July 2009), p. 26.

12 Institute on Taxation and Economic Policy, *Should Sales Taxes Apply to Services?* (2011) and Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues* (Center on Budget and Policy Priorities: July 2009), pp. 17-19.

13 One expert notes that, "There is one circumstance, however, in which expansion of the sales tax to services could make a state's overall tax system somewhat less equitable. That can occur if taxing services raises the proportion of total state revenue that is derived from the sales tax and thereby lowers the proportion that is derived from more progressive sources such as personal and corporate income taxes." Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues* (Center on Budget and Policy Priorities: July 2009), p. vi.

14 The bottom fifth of California households pay 10.2 percent of their income in state and local taxes, while the top one percent pay 7.4 percent after adjusting for the deductibility of some state taxes for federal tax purposes. Institute on Taxation and Economic Policy, *Who Pays: A Distributional Analysis of the Tax Systems in All 50 States* (November 2009), p. 24.

Appendix A: Estimated General Fund Revenue Raised by Specific Services (Dollars in Millions)			
Area of Service or Activity	Annual Revenue	Area of Service or Activity	Annual Revenue
Agriculture		**Business Services**	
Breeding, boarding, etc.	$10	Advertising and related	$478
Drilling and Mining		Office administration	$282
Oil exploration, grading, etc.	$34	Facilities support	$78
Construction		Employment services	$937
Non-residential	$516	Business support	$398
Other heavy construction	$26	Investigation and security	$304
Building foundation and exterior	$159	Building and dwelling	$792
Building equipment	$219	**Subtotal**	**$3,269**
Building finishing	$142	**Entertainment and Recreation**	
Other specialty trade	$103	Film and movies	$86
Subtotal	**$1,165**	Performing arts	$108
Automobile Repair and Service		Spectator sports	$172
Dealers	$627	Promoters	$72
Repair shops	$410	Agents and managers	$115
Towing	$33	Independent artists	$497
Car washes	$39	Museums and similar	$2
Parking	$86	Amusement, gambling, and recreation	$650
Subtotal	**$1,195**	**Subtotal**	**$1,702**
Transportation		**Repair and Maintenance**	
Urban transit	$29	Precision equipment repair	$104
Interurban transit	$5	Mechanical equipment repair	$69
Taxi and limousine	$49	Personal and household repair	$108
Charter bus	$16	**Subtotal**	**$281**
Other transit	$37	**Personal Services**	
Subtotal	**$136**	Hair, skin, and nails	$243
Storage and Warehousing		Dry cleaning and laundry	$187
Refrigeration, self-storage, warehouse, etc.	$160	Other	$270
Mini-storage and self-storage	$54	**Subtotal**	**$700**
Subtotal	**$214**	**Total**	**$8,706**

Source: Letter from Judy Chu, Chair, State Board of Equalization to Honorable Don Perata, et al. (April 21, 2008).