# California's Sales Tax: Widening the Base of Services

## Overview

Broadening the sales tax base is among the most straight-forward of the many difficult decisions facing California right now with its ever-growing, gaping budget deficit. California's budget deficit is cyclical and structural. While the cyclical portion of the deficit will correct as the economy recovers, the structural deficit represents an ongoing issue that will only get worse, creating additional problems in its wake, if agreement can't be reached on how to close it. Expanding sales taxes to include services is an easy, equitable, efficient way to do this. Currently, California only taxes 21 service sectors by comparison to an average of approximately 56 sectors by the other states.[1]

Sales tax revenue has fallen as a percentage of state revenue in California, mirroring a nationwide trend. California sales tax revenue declined from 37% of General Fund revenues in FY1980-1981 to 28% in FY2007-2008, despite an increase in the sales tax rate.[2] The reason for this decline in sales tax revenue is that sales of tangible personal property have been relatively stagnant, but sales of non-taxed services have growth rapidly during the past two or three decades. In some cases, declines in sales taxed items such as video rentals and music CD sales have been offset by increased sales in non-taxed services, including downloads of online movies and music.

## Precedents

The service sector has grown to 168 specific subsectors of which currently utilities is the only service sector that is taxed by almost every state and even then, only some utilities. California is well behind other states in the move to broaden its tax base. Reflecting the growing portion of the economy represented by services, most of the changes in state sales tax bases occurred during the 1970s and 1980s, but have slowed since 1990 after well-publicized repeals of tax base expansion by Florida in 1987 and Massachusetts in 1990, involving business services (Florida replaced it with a sales tax rate increase).

In 2007, Maryland and Michigan both moved to include business services which were quickly repealed (Michigan replaced the proposed services sales tax with a business tax surcharge). While several lessons can be learned from the experience of these four states, the main lesson is to avoid taxation of business services in order to avoid 'pyramiding' or the double-taxation of businesses which, understandably, riles the business community. (More generally, there is an important process that needs to be followed in educating the

[1] The Federation of Tax Administrators started periodically surveying states about which services they tax starting in 1990 and most recently in 2008.
[2] Cal-Tax, Taxation of Services: A Real Disservice, [Date]

public about new taxes before rolling them out that wasn't followed in each of the above cases.[3])

New Jersey is the only state during the last few years to enact legislation to expand the taxation of services and the services covered included storage, tanning and massage services, limousine services, and information services, raising the number of taxable services in the state from 55 to 74 services.

## *Specific Proposal*

The proposed sales tax broadening would include two broad categories of services. The first is a category that includes services which represent the rental or purchase of a good. California has begun to take steps to tax services in this category, but non consistently. For instance, we tax tuxedo rentals, but not similar services (i.e. diaper service, sector 57[4]). We propose extending this to all service sectors which are not currently taxed.

Specifically, this would include Computer Services (sectors 107-109 and 111-112 and 115) and a new category of services called 'Computer Online Services' comprising data processing, downloads of software, books, music, movies and digital video and other electronic downloads (sectors 116 through 121). These are fairly clear examples of where downloads replace the purchase of a good (i.e. music CD, book, etc.).

The second major category of new services we propose to tax represents a category of services which involve the rental of space, including Storage Rental (19-24), Parking Lots and Garages (125) and Admissions and Amusement which comprises 16 subsectors including a broad range of services from admissions to racing events to rental of videos (127-141). In California, the latter is the only service in this category that is currently taxed, but all services in this category deserve similar treatment. Also, we recommend including Limousine services (158) and Chartered Flights (161).

In total, we propose adding 39 service sectors to the existing 21 service sectors California already taxes, for a total of 60 sectors, close to the average for all 50 states, but well

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[3] On the New America Foundation website, a piece by AICPA Corporate Taxation suggested the following to improve the roll-out of new taxes on services:

**Education:** Predictably, adding a tax to something previously untaxed is not popular. A state should pursue education efforts to help consumers understand the sales tax and the benefits of base broadening. Once in place, taxpayers will also need information on when they owe use tax on services obtained from out-of-state.
**Legality:** A state should review federal and state rulings for help in properly defining the expanded tax base. Case law should also be reviewed to aid in drafting rules on nexus and determining the tax on services performed and/or delivered to more than one state.
**Transition:** Implement the expansion gradually. The enacting statute should specify the items added to the base with effective dates spanning a future time period. This allows more time for the tax agency to help businesses that become subject to tax collection, and for consumers to adapt to the changes.
**Compensation:** Base expansion will cause more businesses to be subject to sales tax compliance. A state should provide a refundable tax credit to alleviate start-up costs for these businesses and ideally, provide compensation for all businesses that collect sales tax.

[4] Sector numbers based on attached spreadsheet created by Federation of Tax Administrators (see attachment).

below the top four states (New Mexico, Hawaii, South Dakota and Washington) which all tax over 140 sectors.

Specifically, not included in the list of proposed service sectors to tax are business services and services provided to businesses to avoid the pitfall of pyramiding taxes. Also not included are services which are likely to be consumed by low to moderate income households, thus regressive (i.e. cell phones, inter and intra-state telephone, water, electricity, natural gas, and other utilities currently taxed by many other states)

We estimate that this proposal will result in a revenue gain of $3 to $4 billion per year.

## Pros

Levying a sales tax on a larger number of service sectors would fulfill what all economists and tax experts agree is a hallmark of a good tax system: broadening the tax base. In the 1930s when the sales tax was first proposed, services represented a small percentage of total consumption. Since then, changes in lifestyles and technology have led to changes in consumption patterns with service consumption growing much more quickly than goods consumption. Households now hire house cleaners, gardeners, nannies, personal trainers and pet sitters. Consumption trends also include greater consumption of digital goods.

Economically, there is no rationale for taxing some forms of consumption while exempting others. There is no reason to tax laundry detergent, but not dry cleaning services; a lawn mower, but not gardening services (even though we do not propose to tax those services at this point). When it comes to sales tax reform, the policy answer is unless you've got a really good reason to do otherwise, whatever people buy should be subject to tax. It shouldn't matter where you buy it (on the Internet or in a store).

Broadening the sales tax base to include more services can make the sales tax more equitable and can allow for a rate reduction (making the tax even more equitable). If needed, base broadening and a rate reduction can be combined to generate new revenues. States facing reduced sales tax collections due to a diminishing tax base might find it simpler to increase the tax rate, rather than expand the base. This approach though, ignores the underlying problem and creates others. Many services are more likely to be purchased by higher income individuals. Exempting service consumption while increasing the tax on tangible personal property makes the sales tax more regressive. Also, California already has a high sales tax rates and further increases may lead to competitive problems for businesses and greater tax evasion.

A broader base can also reduce volatility that can improve government budgeting. Base broadening can also help improve economic development decisions. For example, in some states, such as California, local governments are very dependent on sales tax revenues. Thus, they are "incentivized" to get retailers to locate within their jurisdiction rather than trying to attract businesses that offer nontaxable goods or services. A broader base enables governments to make better economic development decisions.

## Cons

One substantive problem with broadening California's tax base to include more services is the possibility of 'pyramiding'. Pyramiding is the application of tax to prior tax amounts in successive commercial transactions and can be exacerbated by taxing more services. The services proposed herein specifically avoid taxes on business services and other labor-intensive services which would most likely cause pyramiding.

In addition, another issue with taxing services is the inequity created if the sales tax applied to necessities which account for a greater percentage of income of low-income taxpayers. However, with many services, taxation would be progressive, since some services tend to be consumed more by higher-income households (i.e. diaper services, private club fees, online downloads, and chartered flights).

The most common arguments against expanding sales taxes to more service sectors is that it is anti-business and will hurt the state's economy. In 1990 when Iowa's Governor proposed to expand the base of Iowa's sales tax to include more business and professional services, many claimed that the expansion would harm businesses and economic growth in the state. A study performed at the time found that the three states that had for many years fully taxed services (South Dakota, New Mexico, and Hawaii) had stronger economic growth than Iowa over the past two business cycles and employment growth in small businesses over the decade of the 1990s was stronger in two of the three states than it was in Iowa. Finally, business formation in each of the three states that fully tax services was higher than it was in Iowa.

Potential legal issues, particularly involving interstate commerce, need to be explored. For instance, Bradley-Burns Uniform Local Sales and Use Tax Law authorizes localities to enact sales tax ordinance at a specified percentage. However, it appears only to apply to taxation of tangible personal property. The question is whether in implementing a services tax on the local level if the Legislature would have to provide authorization to localities to tax services thus requiring each individual locality to hold an election to enact the tax by a majority vote, a costly and time consuming effort.

## Supporters

As noted above, California is far behind other states in the move to recognize the equity argument for taxing more service sectors. Most, if not all, economists and tax experts are supportive of broadening the sales tax base to include more services which in many cases are sales of goods in disguise.

Last year, Judy Chu, the chair of the state's Board of Equalization, was recommending expanding the state sales tax base in a way that could yield up to $10 billion a year. Chu's rationale was consistency and fairness:"We tax exercise equipment, but we don't tax health club services. We tax movie rentals, but we don't tax movie admissions," Chu said.