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## Sales Tax On Services? Again?

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An old friend is back in town, at least according to George Skelton [1]. He shows up every so often trying to settle in, but after making an initial good impression, the neighbors usually politely ask him to keep moving on.

I'm talking about the proposal to extend the state sales tax to services, which is apparently a tax reform being considered by the Governor's Office.

We've been through this before, most recently when the Commission on the 21<sup>st</sup> Century Economy [2] ("Tax Commission") began to consider reforming the tax code to make it more stable and "fit with the state's 21<sup>st</sup> century economy."

Ultimately, the Tax Commission threw the idea overboard, finding:

Among the ways to improve the (state tax) system competitively, expanding the sales tax to include services has serious shortcomings. Picking and choosing how to expand sales tax to services has been difficult for most states in a situation similar to California's. An expanded sales tax would still leave the state with its current system of requiring businesses to pay sales tax on inputs, such as supplies and capital equipment. In addition, imposing the sales tax at the existing high rate would cause a significant economic jolt for newly affected businesses.

The Commission instead opted for a "new broad-based consumption tax," called the business net receipts tax, which for now is languishing in policy purgatory.

Why should this new tax be rejected? For a detailed explanation, I refer you to a paper I provided to the Tax Commission [3] last year. The key conclusions are:

1. A services tax is not needed to change the responsiveness of the sales tax to the economy. The current taxable sales base is already very sensitive to the economy, and adding services would not materially change that.

2. Taxing services that would most likely be added to the sales tax base would only provide minimal opportunity to reduce sales tax rates in a revenue-neutral manner. Increasing the price of a haircut by 9% in return for a quarter-percent or half-percent reduction in the price of a shirt seems to be an odd trade without much economic gain.
3. Increasing taxes on selected (and likely the most politically vulnerable) services would be unfair, discriminatory and economically harmful.
4. Imposing a services tax would increase the cost of labor, which is just the wrong signal when the economy needs to produce jobs.
5. Elsewhere in the country, enacting broad-based sales taxes on services has consistently met with defeat at the hands of targeted industries.

Services differ from tangible goods chiefly in that they are provided immediately, on-site, and by a worker. Whether the activity is lawn care, veterinary, repair, nursing, law, accounting or tattoo, they all involve the labor of an individual to provide the service in real time at the site of consumption. A tangible good that is subject to the sales tax may have been made next door, or half-way around the world.

I've written earlier [4] about how the sales tax base has not eroded to the extent that services tax proponents claim. Drilling down on the nature of the "services economy," the State Board of Equalization in 2008 [5] made the following observations:

- Americans are spending substantially more of their incomes on services than did their grandparents. Since the 1940s, the share of national disposable personal income devoted to services has increased from about 30% to about 55%.
- The largest components of services purchased are housing and medical care, which together amount to 54% of all purchases. Add transportation and 60 percent of services that Americans purchase would never be considered taxable in California.
- The fastest growing components of the services economy (medical care, education, utility services, and legal, bank and brokerage services) tend to be those that would not be taxed; it is the slow-growing services that are the targets for taxation: personal services and spectator amusements.

But can't we increase the sales tax base and reduce the rate? Yes, but here arithmetic trumps rhetoric: the more exemptions from taxation, the less the rate could be reduced.

The widest swath of services ever suggested for taxation in California, by Board of Equalization chair Judy Chu in 2008, was \$183 billion worth of services transactions covering construction, repair, business services, warehousing, entertainment and recreation and personal services. This ambitious approach would enable the overall tax rate to be reduced by about **one-and-a-half percentage points**.

Recognizing this recipe may be a bridge too far, Ms. Chu also presented a mix of services that "are most frequently taxed by other states." That list of services comprised automobile repair and service, entertainment and recreation, repair and maintenance, and dry cleaning and laundry. Amounting to about \$56 billion in transactions, broadening the base would enable a tax reduction of **one-half percentage point**.

Imposition of a new tax on services would be unfair, harmful to jobs and the economy, and ultimately ineffective. Since a service is by definition intangible, it can be provided in a variety of ways that can defeat the tax:

- Companies that previously had contracted out for a service may decide to provide the service in-house.
- Out-of-state (or out-of-country) providers would have an advantage over in-state businesses. Many companies have overcome the existing high cost of labor in California by outsourcing jobs to other states or countries. And while these services may be subject to a use tax, enforcement of that tax is notoriously lax.
- In-house vs. out-of-house and in-state vs. out-of-state will provide some companies with significant competitive advantages over other companies. Large businesses will be much better able to avoid this tax than will small businesses.

Finally, the experience of other states that attempted to impose a comprehensive services tax should not be encouraging to those who may wish to take this step. Over the past two decades, three large states have adopted broad sales taxes on services - and then repealed them within months.

In 1987, Florida enacted a broad sales tax on services, which covered all manner of personal and professional services, including purchases from out-of-state providers. Within six months, the state legislature repealed the tax, replacing it with a penny increase in the sales tax on tangible goods.

In 1990, Massachusetts expanded its sales tax to services, but repealed it before the effective date.

And in 2007, Michigan adopted a sales tax on a wide range of mostly personal services. It was repealed before it even went into effect.

Most recently, Maryland repealed its expansion of the sales tax to computer services. Passed in November 2007, and set to become law the following July, the Legislature repealed it before it could take effect.

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[1] <http://www.latimes.com/news/local/la-me-cap-20100819,0,5993389.column>

[2] <http://www.cotce.ca.gov/>

[3] <http://www.cotce.ca.gov/documents/correspondence/public/documents/CFCE - Tax Commission White Paper.pdf>

[4] <http://www.foxandhoundsdaily.com/blog/loren-kaye/the-sales-tax-base-just-fine-thanks>

[5] [http://www.boe.ca.gov/news/pdf/ep\\_Nov08.pdf](http://www.boe.ca.gov/news/pdf/ep_Nov08.pdf)