



Taxation of Services: A Disservice to California

Background: Talk of taxing services has been around for some time, typically proposed in the name of “modernizing the economy,” closing California’s budget gap, and stabilizing cyclical fluctuations in tax revenues. Some argue that a change in consumption patterns has led to a drop in sales tax revenues.

Yet, taxed activity, such as the purchase of tangible goods, tends to grow slower than untaxed activity precisely because it is taxed. If services are taxed, the growth rate will slow. Some estimate that a broad sales tax on services could generate as much as \$45 billion annually in new revenues. However, the real question with regard to taxing services is whether expanding the base would result in an overall benefit to the state and whether that benefit would outweigh the natural, but likely unintended, consequences that would flow from such an expansion.

Other States: 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other states have been reluctant to undertake a broad-based expansion of the sales tax base since Florida enacted and repealed expansion of its base in 1987 and Massachusetts enacted and repealed its base expansion in 1990 in response to strong opposition. Although Michigan and Maryland attempted similar expansions, they joined Florida and Massachusetts in repealing services taxes shortly after enactment. (See discussion below.)

Although many states tax some services, a trend toward expanding the sales tax base to include more services is not at all apparent. Only Hawaii and New Mexico have broad-based sales taxes on services, according to the FTA survey.

Four States Experienced Major Public Outcry in Response to Broad Services Taxes

- ✓ **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. Unanticipated, however, was major opposition in the business community, assailing the tax as extending beyond its borders and substantially increasing the costs of advertising, news, and legal services. Reportedly persuaded by public opinion polls, the Governor of Florida withdrew his support for the measure after it took effect. Florida enacted its services tax in July 1987 and repealed it six months later in December.
- ✓ **Massachusetts.** The Massachusetts services tax, enacted in 1990, attempted to tax only services provided to businesses. These services included legal services, accounting, auditing, bookkeeping, engineering services and architectural services. If these services were used by Massachusetts businesses, they would be taxed irrespective of where they

were performed. Services used both within and outside of Massachusetts were apportioned based on the corporate income tax apportionment formula. The tax created competitive disadvantages for service providers located within Massachusetts. Massachusetts repealed its services tax shortly after enactment.

- ✓ **Maryland.** In 2007, the Maryland State 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 employ 68,000 people with an annual payroll of \$5.2 billion. The tax was repealed in 2008 after tremendous pushback from industry. According to the National Tax Foundation, nine states now tax computer services, and litigation has arisen in several states regarding the difficulty of separating computer services and other types of services.
- ✓ **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 services, janitorial services, landscaping services, warehousing, packaging, procurement, and personal services. A Coalition, known as the “Ax the Tax Coalition” was formed to petition for repeal of the tax, arguing that it would hurt Michigan’s economy and force jobs to leave the state. According to a Michigan Chamber of Commerce poll, 90 percent of respondents supported repeal of the tax. The tax was also widely opposed by the financial services industry and the logistics industry. Before it reached the ballot, however, it was repealed, just 17 hours after its effective date.

Taxation of Services Is a Disservice to California.

- ✓ **Double-Taxation on Businesses.** According to the Center on Budget Policy and Priorities, economists recommend against taxing business-to-business sales, as it leads to “tax pyramiding.” Tax pyramiding is a term used to refer to the phenomenon of taxing an input when purchased and taxing it again when the cost is passed on to the consumer. When businesses pay more for inputs, consumers pay more at the cash register.
- ✓ **Discriminates Against Small Businesses.** Larger businesses that can afford to hire employees to do the work of an independent contractor would not pay tax on the service performed by the employee. Smaller businesses, however, would be forced to pay a tax, as they must contract out these services. This results in higher costs on small businesses that must pay tax on the same services used by large businesses that don’t pay the tax.
- ✓ **Inflationary.** Adding significantly to the cost of all services virtually overnight will be highly inflationary. This cost includes the increase in tax rate (varies by proposal, but could reach almost 10 percent), as well as a cost of administering the tax, which will be passed on to the consumer. This will ripple through the economy, creating increased pressure for wage

increases, which will lead to job loss and potentially lost revenue from the Personal Income Tax.

- ✓ **Regressive.** Studies have shown that expanding the tax on services is more regressive than California's current sales tax. Such impositions would require lower-income individuals to pay a larger portion of their income for service taxes than higher-income earners. Repair services are particularly integral to budgets of families who cannot afford to purchase a new appliance or a new car, or whose home is past its prime. Tax would now be paid on services to repair the car, fix leaky pipes or replace a roof.
- ✓ **Hurts Working Families.** A tax on admissions would increase ticket prices to places like Disneyland, Six Flags, and sporting events of all kinds. In this economy, working families simply do not have the disposable income to support a tax on non-necessary activities, and instead will forego the activity altogether.
- ✓ **Worsens Business Climate.** California services would have a significant competitive disadvantage compared to services provided in other states. Companies based in California that could obtain less costly services from out of state would do so. The motion picture industry, already hurt by runaway production, would suffer a major blow. If this tax were added to all movie industry-related services, fewer films would be made in this state, and many film production jobs would be lost.
- ✓ **Widens Tax Gap.** Because a new tax on services would be imposed on many cash businesses, much of this tax would go uncollected. These businesses would migrate to the underground economy, and the "tax gap," the difference between taxes owed and taxes paid, would grow substantially larger.
- ✓ **Local Implementation Problems.** Under the Bradley-Burns Uniform Local Sales and Use Tax Law, localities are authorized to enact sales tax at a specified percentage. This authorization, however, appears only to apply to taxation of tangible personal property. To implement a services tax on the local level, it appears the Legislature would have to provide authorization to localities to tax services, and each individual locality would have to hold an election to enact the tax by a majority vote. This would be costly and time-consuming.