WASHINGTON RESEARCH COUNCIL

POLICY BRIEF

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Sales taxation of services: the good, the bad and the costly

Overview

In attempting to close the state budget shortfall by imposing sales taxes on business and professional services, Gov. Lowry and the Legislature are out of step with most tax experts. Several states have already taken the path Washington is considering. Some, however, have repealed the new taxes in the face of opposition from business and the public.

Some economists support widening sales tax bases to improve tax systems because of a long-term economic shift toward service industries. Most, however, oppose singling out business and professional services.

Taxing services purchased primarily by businesses results in multiple taxation, because the service becomes part of a final product that is eventually taxed at its retail value. The tax creates hardships for small businesses and entrepreneurs that cannot afford to supply services in-house, as can larger firms. The administrative burden of the tax is also especially hard on small businesses. The mobility of many business and professional services means that the state will suffer a competitive disadvantage vis-a-vis states that do not levy these taxes. Because of its tax structure, Washington already taxes services more heavily than do most other states. If sales taxation of these services has the economic results that many experts believe, it is unlikely that the state will realize the revenues that it projects. Taxpayers and the economy would be better served if the state sought further reductions in spending or temporary surtaxes to resolve its budget problem. If the state is fixed on its present course, it should be prepared to closely monitor the effects of these new taxes and modify them later, as other states have done.

Faced with a 1993-95 budget deficit forecast as high as $1.8 billion, the Washington Legislature has moved swiftly this year to raise new revenues by extending the retail sales tax to a long list of services. Gov. Mike Lowry indicated before taking office that, should he find new taxes necessary, he would favor broadening the base of the sales tax to include more services, rather than raising rates on existing taxes or seeking a new tax on personal income. He further specified that the new services to be taxed should be limited to those purchased by businesses, rather than by individual consumers.

The $940 million tax proposal released by the governor on March 24 closely followed these intents. Some $787 million of the package, or about 84 percent of the total, was derived from applying the state's 6.5 percent retail sales and use tax to what he referred to as selected business services. These included at least 45 distinct services in 18 broad categories that the governor stated were consumed primarily by businesses rather than by individuals. Some of the larger areas included:

- secretarial and clerical services
- most forms of computer services
- data processing services
- information services including electronic data retrieval
- legal services including arbitration and mediation
- accounting, auditing, bookkeeping, tax preparation and similar services
- engineering, surveying and architectural services
- almost all forms of business consulting and management services
- public relations and some advertising services
- financial management and consulting services.

The Senate followed on April 2 with a $626 million tax package that included extension of the sales tax to a list of business services very similar to that proposed by Gov. Lowry, with the addition of several consumer services such as laundry services, beauty and barber services, and amusements and recreations not otherwise taxed. While vastly broadening the base of the sales tax, the Senate dropped the rate to 6.0 percent. A $638 million plan presented by House Democrats on April 13 was modeled closely on the governor's, though the House also opted to drop the rate to 6.25 percent. The final package agreed to by House and Senate conferees is expected to be a mix of the three plans.

The retail sales tax was established in Washington in 1935 as a tax on the selling price of tangible goods sold at retail. As in most states, services were by definition exempt unless otherwise enumerated. Over time, a number of services have been included in the definition of retail sales, including repair of tangible personal property in 1939, construction in 1941, rental of tangible personal property in 1959 and amusement and recreational activities in 1961.

Extending the tax, which now accounts for about 50 percent of general fund-state revenues, to a much broader range of services than at present has potential over the long term to increase the stability and elasticity of the state's revenue system. The impact of such a change on the proportionality of the system is much less certain. While endorsing expansion of sales tax bases in concept, most tax economists view the singling out of business and professional services for coverage under the sales tax with disfavor.

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Recent state activity

Sales taxation of services has been among the leading issues in state tax policy in recent years. **Connecticut**, for example, applied the sales tax to a long list of consumer and business services to help close a large budget deficit in 1989. New taxable services included tax preparation, lobbying, motor vehicle repairs and house painting. The Connecticut legislature further extended the list of taxable services, while cutting the sales tax rate, as part of the restructuring of the state's tax system in 1991.

A number of states took similar action on the sales tax in 1991, a record year for state tax increases. **New York** and **Texas** added telephone answering services to their sales tax base; **Ohio** added lawn care, landscaping and detective and protection services; and **Pennsylvania** added lobbying, data processing, building maintenance and credit reporting and collection services. **Massachusetts** went in the other direction, repealing the sales tax on general business and professional services that was enacted the year before. Had the 1990 legislation remained intact, Massachusetts would have had the broadest coverage of services under its sales tax of all states.

The **Florida** legislature considered proposals this year to apply that state's 6 percent sales tax to a list of 25 services now exempt. These include accounting, appraising, architecture, collection, dating services, dry cleaning, engineering, lobbying, interior decorating, legal services, management consulting, securities brokerage, telemarketing and vehicle road service. A bill extending the sales tax to virtually all computer and information services passed the Florida House, but failed in the Senate. This was Florida's second attempt to obtain increased revenues through broad inclusion of services in its sales tax base. Similar legislation was passed in 1987, but repealed later that year after a storm of opposition from the tourism, advertising, legal and other businesses and professions adversely affected by the new taxes.

According to Corina Eckl of the National Conference of State Legislatures, several other states have undertaken expansion of their sales tax bases over the last year. **Iowa** added a number of newly taxable services effective April 1, 1992. These included aircraft leases, dating services, sign construction and installation, storage of household goods, limousine services and several others, most of them consumer services. A broad-based tax on consultant services, however (including business, computer, management, marketing and others) was repealed by the Iowa legislature in May. **Maryland** extended the sales tax to an array of services, including janitorial services, telephone answering services, pay per view television, mobile telecommunications and security services. **Ohio** passed a tax package in December to balance its budget that included expanding the sales tax base to building maintenance, pest control, recreation and fitness facility memberships, and temporary help and employment services.

Like Florida in 1987 and Massachusetts in 1991, **Pennsylvania** reversed its course on taxation of services in 1992. A long list of both personal and business services that had been included in the sales tax increase enacted in 1991 were exempted shortly after due to concerns about equity and economic impact.

State fiscal experts express concern about a deteriorating relationship between states' economies and their revenue systems.

A structural problem? State economies and state revenues

One reason for the recent surge of interest in taxation of services is simply that it is seen as a relatively untapped source of new revenue for states experiencing fiscal difficulties. It may also be seen as politically easier to accomplish than raising existing sales and income tax rates, especially in light of the major increases in these taxes in many states in the late '80s and early '90s. (It is no accident that services provided by politically potent groups, such as legal services, communications and advertising, are often left out of these tax packages.)

A more important reason for the increased focus on services in tax policy is the recognition of the changes that have occurred in the national economy over the last three decades. State fiscal experts express concern about a deteriorating relationship between states' economies and their revenue systems.

In this view, the sales tax, devised as a levy on transactions in tangible goods in an era when manufacturing dominated most states' economies, is poorly suited to economies increasingly oriented toward transactions in services.

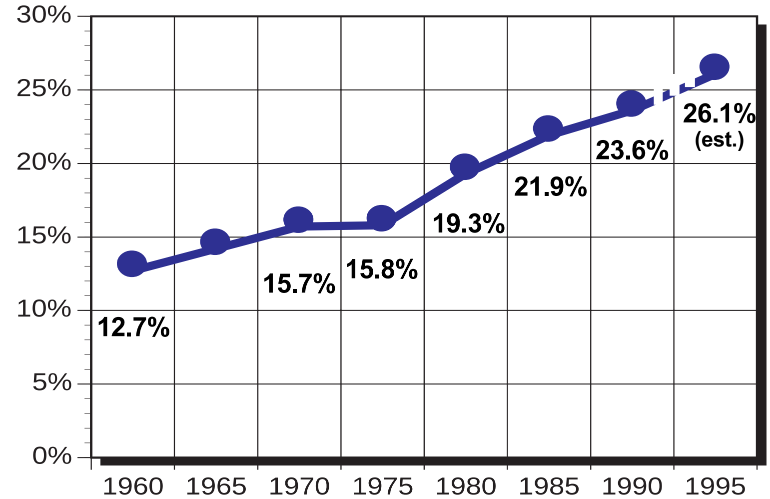
A draft report circulated by the National Association of State Budget Officers, the National Conference of State Legislatures and other national groups asserts that "States have substantially failed to update sales taxes, business taxes and property taxes to reflect the shift toward a service-based economy." They point out that the share of personal consumption spent on services in the U.S. increased from 26 percent in 1960 to 42 percent in 1991. As a percentage of U.S. gross domestic product, services have grown from about 60 percent in 1970 to more than 70 percent in 1991.

This shift is evident in economic data for Washington state. According to Forecast Council data, services employment as a share of total Washington nonagricultural employment has grown steadily from 12.7 percent in 1960 to an estimated 25.3 percent in 1993. Services employment is expected to rise to a 26.1 percent share in 1995. During the 1980s, the number of manufacturing jobs in Washington grew by about 20 percent, while the number of services jobs grew by 98 percent.

The result of this long-term change in state and national economies is that one of the workhorses of most states' revenue systems, the sales tax, is applied to a shrinking share of economic activities. Allowed to persist, the result will be that over time state revenues will grow more slowly than state economies. In the language of tax analysts, the elasticity of state revenue systems — defined as the relationship between economic and revenue growth — will gradually deteriorate.

Doug Olberding of the Council of State Governments notes that the average elasticity of state sales taxes has been declining steadily since about 1984. Washington's sales tax ranked 10th among 45 states in adjusted elasticity between 1977 and 1990 at 1.17, compared to a state average 0.95. (A coefficient of 1.0 means that revenue increased at the same rate as personal income over this period.) More study would be needed to determine whether the Washington figure has been following the national trend toward a decline in recent years. (Olberding, "Taxes to Grow With." *State Government News.* February 1993.)

Percentage of Washington Employment in Services



A broad consensus prevails that if the sales tax is to be applied to more services, it should be to consumer services, not business and professional services.

Many economists advise widening sales tax bases to include more services, as Gov. Lowry has proposed, to correct this "structural problem" in state revenue systems. "Much of the activity of the early 1980s focused on raising rates," says William Duncombe of Syracuse University. "But since 1987 there has been a concerted effort to expand service taxation." (Olberding, 1993). According to Hal Hovey, publisher of *State Budget and Tax News*, "This concept has considerable support among tax policy experts, which means it is 'on the shelf' in practically every state as among the ideas to be drawn upon in times of fiscal difficulties." ("State and Local Tax Issues in the '90s," in Stocker, *State and Local Fiscal Policies*, Lincoln Institute, 1991)

Sales taxation of services finds support among economists on grounds of equity as well as efficiency. They argue that consumption is consumption, whether the object consumed be a good or a service, and an equitable and rational consumption tax should not, generally speaking, discriminate between the two. Why, for example, should video rentals be taxed, but movie tickets be exempt? Economist John Mikesell of Indiana University argues in *Reforming State Tax Systems* that "[t]here is no reason why private purchases of services should be treated differently from purchases of tangible personal property. Both are consumption expenditures: to tax commodity purchases but not service purchases discriminates according to consumption preferences and sacrifices a portion of the legitimate tax base."

Taxation of business services finds little support

In one important respect, however, the view of Gov. Lowry and legislative leaders is out of step with the thinking of most tax economists. A broad consensus seems to prevail that if the sales tax is to be applied to more services, it should be to consumer services, not business and professional services.

Mikesell, a leading expert on the sales tax, argues that "while a strong case can be made for the widest feasible inclusion of purchases made by individuals, . . . business purchases should be exempt to the greatest extent feasible. Any inclusion violates precepts of a single-stage consumption tax and should be unattractive to legislators seeking to encourage economic development." This applies equally to services, Mikesell says, as to commodities. The argument for exemption of business purchases of services from the sales tax is essentially the same as for purchases of component parts and materials, which are now exempt in every state except Hawaii: Both become part of the cost of a finished product, which is then taxed once at its total value.

Pyramiding of sales taxes

Steven D. Gold, director of the Center for the Study of the States at the State University of New York and one of the most respected authorities on state finances, lends further support to this view in *The State Fiscal Agenda for the 1990's*. According to Gold, the case for making business and professional services subject to sales taxes "is not as strong as for consumer services because they add to the cost of doing business and are likely to be passed along to consumers in the form of higher prices. Moreover, pyramiding of the tax can occur, with a subcontractor paying the tax once and then its customer paying it again. Many economists view the sales tax as a tax on consumption, and from that perspective it should be only on consumer, not business purchases." Some defenders of sales taxation of business services, Gold adds, insist that there are ways to mitigate the "pyramiding" problem through the design of specific taxes. We know of no instances, however, where this has been achieved.

The issue of tax pyramiding looms large in a 1992 report by the Minnesota Department of Revenue, *A Model Tax System for Minnesota*. While professional services are rendered to both businesses and consumers, the report stated, most are rendered to businesses. "Taxation of these services provided to businesses would create 'pyramiding' or multiple taxation, with both the service and the final product taxed. With pyramiding, the effective tax rate on consumers could vary significantly by type of final product or service."

"Business services eventually become part of a final product that is taxed; the service ends up being taxed twice."

State of Washington Dept. of Revenue

Economic impact: distortion, inequity and tax competition

The Minnesota tax department listed a number of other reasons to exempt services provided primarily to businesses. First, the tax would encourage business firms to hire their own professionals (i.e., lawyers, accountants and computer specialists), in which case the sales tax would not be paid, while the same services purchased from outside would be taxed. This would create unproductive use of resources by larger firms that could afford to supply themselves with services "in-house," and tax inequities for smaller firms that could not.

William Duncombe of Syracuse University raises the same concern in a recent article in the *National Tax Journal* ("Economic Change and the Evolving State Tax Structure: The Case of the Sales Tax," 44, Sept. 1992). "Business service taxes, such as those proposed in Massachusetts," Duncombe says, "raise the possibility of vertical integration by firms and other tax avoidance." In other words, firms that previously hired other firms would have strong tax incentives to either buy up the service-providing firms or hire staff to do the job in-house. This outcome runs counter to the established principle that states should generally avoid tax policies that create distortions in market behavior and encourage businesses to engage in unproductive activities.

The Minnesota Revenue Department report also noted that "States that tax business services may have a competitive disadvantage compared to states that do not." This could be a significant issue, it said, in interstate tax competition. A recently published report by John Berthoud, fiscal policy director at the American Legislative Exchange Council, puts considerable emphasis on this point. "In our high tech era, many businesses in a state with a sales tax on services can shift services to out-of-state businesses that don't face this constraint," Berthoud says. "A multistate firm can make purchases of services outside the state applying the tax. A small single-state firm cannot do this. Multistate firms will not locate their headquarters in service sales tax states because of the new tax burden that all the activities that this headquarters will perform will incur. . ." Wharton Econometrics estimated that the Florida services sales tax would have cost the state 11,000 jobs and $600 million in business over a 30-month period had it remained in effect. (ALEC, "State Budget Reform for the 1990s," April 1993)

The Washington state Department of Revenue is well aware of the problems associated with sales taxation of business services. In a report to the Governor's Council on Education Reform and Funding, the department cited many of the same concerns about efficiency, equity and competitiveness that are raised in such abundance in the literature on the issue. ("Possible Revenue Options for Funding Education in Washington, Sept. 1992.) Pyramiding of taxes on businesses, the department acknowledged, is a significant problem for this tax. "Business services," it said, "eventually become part of a final product that is taxed; the service ends up being taxed twice." It agreed that smaller firms would pay a disproportionate share of the tax because they have much less ability than larger firms to provide services to themselves.

The state revenue department also agreed that in the age of the fax machine and the computer chip, when many business and financial services can easily be purchased out of state, Washington service industries are likely to suffer a loss of business if they are forced to charge sales taxes to their customers. Brokerage, public relations, architectural and financial management services, for example, are just as easily provided to a Washington business from Portland as from Seattle.

Computer services, which are both highly mobile and highly entrepreneurial, seem especially vulnerable to the impact of heavy sales taxation. Florida TaxWatch, a non-profit tax research group, argued strongly – and successfully – last month against the proposal to levy sales taxes on computer services there. "The computer industry," the group said, "is . . . one which Florida is trying to attract. Such a tax could hurt our state's competitiveness in encouraging such industries to locate here." One can hardly overstate, of course, the importance of the computer industry to Washington's economic future.

All of these factors should raise concerns, both economic and fiscal, about such a change in state tax policy. Washington state government has relatively little actual experience with sales taxation of services. Should the economic effects of these taxes be as great as most experts suggest, it is very likely that the state will not realize the revenue that it projects from the tax packages that have been proposed in this session. If that is, indeed, the case, the legislature will be back again, either next year or the year after, attempting to make up yet another "revenue shortfall."

The progressivity issue

An explicit premise of the Lowry tax proposal is that it would lend greater progressivity to the state's tax system, on the grounds that the business and professional services to be taxed are "primarily those used by businesses and the wealthy." The governor said that by "choosing to close loopholes," he had greatly reduced the effect of his tax package on the general public.

Extending a tax to something that was never, from the inception of the tax, intended to be taxed cannot fairly be called "closing a loophole." It is also far from certain that all the new services to be covered under the tax are primarily consumed by businesses and "the wealthy." Such services as tax preparation, legal services, protective services and certain computer services, all of which would be covered under the governor's and the legislature's proposals, are surely consumed by a great many individuals who do not fit any reasonable definition of "wealthy."

The greater difficulty with the Lowry assessment of the burden of his tax plan is that it appears to assume that business taxes are in fact paid entirely by businesses, and that none of their cost is passed on to the ultimate purchasers of goods and services.

This is simply bad economics. While it may be an oversimplification to say businesses pay no taxes because they simply shift them elsewhere, it is a worse error to presume that the burden of taxes levied initially on business activities are paid entirely, or even mostly, by those businesses. This is especially so with taxes levied on "intermediate" goods that are used in the production of other goods and services. Many of the services that would be taxed under the governor's plan, such as computer services, engineering and business consulting, fall into this category. According to Aronson and Hilley, "The tax on goods used in production is shifted forward and becomes a cost of the relevant consumer goods that, in turn, are taxed when sold at the retail level." (*Financing State and Local Governments*, 1986.)

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There is far from total agreement as to the nature and extent of the tax shifting that takes place. According to Duncombe, determination of the distribution of the burden of business services taxes requires a sophisticated input-output analysis in which the price increase of an intermediate service is traced through the economy until some share can finally be attributed to the business owner and his employees, and some share to an ultimate consumer. The proportionality of the tax then further depends on assumptions made about the incomes of these consumers in relation to those of the producers. Different industries are also likely to be able to pass on differing shares of the burden of these taxes to their consumers. We have seen no evidence that the governor's estimate that his tax proposal will cost the average family of four only a little more than $2.00 a month (or the price of one tall Seattle latte) is based on an analysis even approximating that level of sophistication.

Evidence for the progressivity of extension of the sales tax to business and professional services is, in fact, quite mixed. James Francis, director of research for the Florida Department of Revenue at the time of Florida's services tax debacle, asserts that "the most favorable change that inclusion of services can create in the overall incidence or economic burden of a sales tax will occur only with the inclusion of professional services in the base." ("The Florida Sales Tax on Services," in Gold, ed., *The Unfinished Agenda for State Tax Reform,* 1988.) The Washington revenue department concurs that adding the sales tax to all services "would generally be considered more progressive than the current sales tax since lower income families and individuals spend proportionately less on services than those with greater incomes."

This result, however, is far from certain. Duncombe cites studies by Bohm and Craig (1987) and Siegfried and Smith (1991) indicating that while taxation of financial services is progressive, taxation of most business and professional services tends to be proportional or regressive, depending on the mix of services taxed. These are not inconsistent with earlier findings. David Davies, for example, concluded in a 1969 study that taxing services had little impact on the distribution of the sales tax burden. ("The Significance of Taxation of Services for the Pattern of Distribution of Tax Burden by Income Class," in Due, *State & Local Sales Taxation*, 1971.)

Administrative burdens

A further consideration is the raft of problems involved with the administration of sales taxes on services. As Berthoud notes, taxes on services are exceptionally difficult to administer because they are "an entirely different type of tax than just a tax on the end sale of a product." A great number of new vendors would have to register with the state, most of them small businesses that will add little to the tax base, but add enormously to administrative burdens. Florida's short-lived 1987 services tax required registration of 95,567 businesses, a 75 percent increase in the number of state-registered vendors.

The administrative burden of the new tax will be at least as heavy on the private sector as on the state, and much of it will fall on small businesses who are least able to cope with it. Wharton Econometrics estimated that the Florida tax would increase administrative costs for state businesses by 14 percent.

Washington already a heavy taxer of business services

Advocates of new taxes on business services also neglect the fact that Washington already taxes services more heavily than most other states. A 1985 study cited by Mikesell that categorized state tax bases as to coverage of services placed Washington among only three states in the "broad" category, since, in addition to selected sales taxes, so many services fell under the state's general business tax, the business and occupations (B&O) tax.

A more recent report by the Federation of Tax Administrators published in draft form by the Institute of Property Taxation follows Mikesell's analysis. The FTA report ranks Washington third highest in the nation in taxation of services in 1992. According to the report, of 163 services included in the survey, Washington taxes 151. It is one of only six states to tax more than 100 services. It is tied with several other states in the number of personal, business and professional services taxed at 20 personal services, 34 business services and 8 professional services. (*Sales Tax Report*, Dec. 1992 — Jan. 1993) The broad reach of Washington's B&O tax appears to account for its high ranking.

The FTA report adds further weight to previous findings that businesses already bear a substantially larger share of the overall tax burden in Washington than in other states. In *Interstate Comparison of Business Taxes* (1988), University of Washington economist James McIntire showed that the business share of initial tax payments accounted for 44 percent of state and local revenues in Washington, compared with a national average of 35 percent.

Washington already taxes services more heavily than most other states.

Adoption of the tax package proposed by the governor and the legislature this year appears certain to widen the gap in business tax burdens between Washington and other states. Combined with the costs of other new taxes and regulations at both the state and federal levels, this new tax burden is likely to have a substantial impact on the ability of Washington businesses, especially small businesses, to meet the competitive challenges of the 1990s.

Conclusion

Extension of sales taxes to services may be seen as an attractive alternative to spending reforms or other tax increases. We should also, however, be fully aware of the implications of such a major tax change for the equity of the state's tax system and for its economy.

The Washington Research Council and others have presented numerous ideas for further spending reductions and reform of state government. A temporary surtax on existing taxes, combined with further actions to control spending growth, would better serve the state than the current plan.

If it is resolved on its present course, Washington should closely monitor the effects of services sales taxation and, like other states that have plunged into this area and later regretted it, be prepared to make necessary modifications later. – *JSA*

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