Sales Tax on Services

No Solution for Budget Volatility; Hurts Small Firms, Increases Costs

In November 2020, the Legislative Analyst's Office (LAO) reported that the state budget was projected to have a $26 billion surplus. While the news is certainly welcome, the LAO warned that there would be a structural deficit in the long term which will increase the pressure for legislators to find new revenue in order to avoid having to make tough budget cut decisions. One revenue-generating proposal that has been debated for years—even proposed in legislation—is a sales tax on services.

California generally does not impose a sales tax on services, only on goods or products. A services tax sounds simple and straightforward—a tax levied on services providers for certain services transactions. But the application of such a tax is much more complex. Depending on the scope of the services included, it could tax services provided by lawyers, accountants, consultants, plumbers, hairdressers, and the list goes on. While there presumably will be a number of tax proposals in 2021, a proposal to tax services is a likely candidate.

PROPONENTS AIM TO UPDATE SYSTEM, CURB BUDGET VOLATILITY

California's tax system generates enormous revenue growth for state programs during years of fiscal health as a result of income taxes paid by upper-income taxpayers. When Governor Edmund G. Brown Jr. was facing a budget deficit in 2012, he successfully pushed to increase taxes for single filers making $250,000 or more and married taxpayers earning at least $500,000. He also increased the top tax rate to 12.3% for filers earning $500,000 and above, or $1 million per couple while temporarily hiking the state sales tax to 7.5%.

When the California economy was enjoying another prosperous year in 2016, the top 5% of California income earners accounted for 66.6% of the state's total revenue. While the state's boom years lead to overflowing general funds, the bust years have the opposite impact. California's overreliance on the top earners was responsible for a budget shortfall of $26 billion during the height of the recession in 2011 and ultimately contributed to what was expected to be a $21 billion surplus only nine years later at the beginning of 2020. The state's overreliance on personal income taxes as a funding source leads to periods of feast and famine depending upon the economic climate.

According to a Senate Governance and Finance Committee analysis on a services tax, although the state's revenue system has performed well in recent years, its tax structure is volatile, resulting in unanticipated budget shortfalls which then necessitate cuts to key public services. The top 1% of taxpayers pay half of the personal income tax, which makes up about 70% of General Fund revenues. As a result, changes in state revenues usually overstate or understate changes in the economy and rise and fall according to the fortunes of Californians with the highest incomes.

Accordingly, supporters of a services tax argue that California should broaden the sales tax base to include services in order to limit the state's reliance on the personal income tax of the top earners and reduce volatility. Until the pandemic-caused shutdown of much of the economy, sales tax revenues in California have experienced uninterrupted growth since the first quarter of 2010. Additionally, in 2018, the U.S. Supreme Court decided *South Dakota v. Wayfair, Inc.*, which held that states may charge tax on purchases made from out-of-state sellers. This has boosted state revenues and contributed to sales tax stability.

According to Senator Robert Hertzberg (D-Van Nuys)—a proponent and author of prior bills to enact a services tax—the state's economy was based on agriculture in the 1950s but has transitioned to a modern, services-based economy. He claims the state has not updated its tax code to reflect this shift. Sales and use taxes accounted for 61% of the General Fund revenues in 1950 and, as of 2018, account for about 20% of the General Fund.

When Senator Hertzberg advocated a services tax, he indicated that it would broaden the state tax base gradually, reaching 3%

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for services by 2023. He also said a services tax proposal was revenue neutral and would synchronize a reduction in sales taxes on goods by 2%. This tax reform would help California deal with volatility and provide working families with tax relief.

OPPONENTS ARGUE SERVICES TAX FAILS TO SOLVE BUDGET VOLATILITY AND WILL INCREASE COST OF LIVING

No matter how a services tax is structured, the fact remains that it is still a tax. Whether it is a broad proposal to tax all services, or a proposal to tax only a handful of services utilized by the wealthy or businesses, a services tax will not solve California's budget volatility. The state's budget volatility stems from California's reliance on the personal income taxes of the highest income earners, an issue that a tax on services does not address.

According to research conducted by Justin L. Adams, Ph.D., for the California Foundation for Commerce and Education in 2019, services that would be taxed are sensitive to the state of the economy and would themselves add to budget volatility. Further, Dr. Adams concluded that a services tax would not reduce volatility because the state General Fund would continue to have a heavy reliance on personal income taxes

In addition, taxing services utilized by the general population will only increase the already-high cost of living in California. Narrowing a proposal to tax only services utilized by the wealthy or used only by businesses will hit small businesses the hardest, discourage growth in California and ultimately create job loss.

According to Dr. Adams' research, large corporations would be able to avoid a tax on services by bringing in house many of the affected services—like legal, accounting or consulting.

In contrast, nearly 90% of small businesses have fewer than 10 employees and couldn't afford to bring these services in house, putting the smaller firms at a cost/price disadvantage with large corporations.

The burden of complying with this new tax would also be more challenging for the small businesses that provide business services—as they likely have limited resources to set up a new tax system within their companies. Additionally, such small businesses could suffer a loss of customers and revenue due to higher prices for their services.

Moreover, the increased costs of business services caused by a services tax will disproportionately hit small businesses, which frequently have lower margins than larger businesses. Further, small businesses are struggling to survive the pandemic-induced recession. Forcing them to pay a services tax on all day-to-day functions—including information technology, janitorial, bookkeeping, etc.—will make an intensely difficult business environment unmanageable.

Taxing business services also will increase the cost of producing and selling goods in California. Many services are needed to bring a product to market, including research and development, quality control testing, advertising and transportation. These costs ultimately would be passed on to consumers—with higher prices having a disproportionate impact on working families.

RECENT SERVICES TAX LEGISLATION

Over the last several years, Senator Hertzberg has introduced five bills to impose a sales tax on most services in California. Proponents tabbed the bills as vehicles that would modernize California's tax structure and curtail the state's infamous budget volatility. Many economists, however, argue a services tax is poor fiscal policy because of the "pyramiding" effect where the tax's costs on services are passed on and repeatedly taxed again through the production chain. These tax costs can snowball rapidly and add serious costs to end consumers, particularly in services-intensive sectors.

In 2018, Senator Hertzberg tried a different approach with the introduction of SB 993. Rather than attempting to continue taxing *all* services, Senator Hertzberg focused SB 993 on taxing only services *paid for by businesses.*

SB 993, labeled a job killer by the California Chamber of Commerce, received a hearing in the Senate Governance and Finance Committee, but was not voted on by committee members. Had SB 993 passed, it would have done the following:

- Created a 3% sales tax on services purchased by businesses (with some exemptions);
- Provided a 2% decrease on the sales tax of goods; and
- Required sellers of business services to collect the tax at the time of sale if the benefit of the services was received in California.

Senator Hertzberg's proposal to offset the increased services tax with a decrease in the sales tax on goods ran the potential of increasing volatility. Many business services—such as legal and bookkeeping services, architecture and design, and other services related to business sectors—are vulnerable to economic ups and downs. Alternatively, while the demand for some goods rises and falls with the economy, many items subject to sales tax remain in demand, such as clothes, alcoholic beverages and household goods. Thus, if California relied more on services taxes and less on sales taxes for budgetary purposes, volatility would naturally prevail.

An analysis prepared by Dr. Adams in May 2019 for the

California Foundation for Commerce and Education found that a 5% sales tax on business services would have the following impacts:

• The average cost of a new single-family home would increase by more than $16,500;

• The average construction cost for a new school would increase by more than $17 million; and

• Costs for public infrastructure like roads and bridges would rise by 3.2%.

ANTICIPATED LEGISLATION IN 2021

It is anticipated a bill like SB 993 could be introduced during the new legislative session—an especially strong sentiment given the state's overreliance on personal income taxes. Moreover, Governor Gavin Newsom has repeatedly expressed support for tax reform to modernize California's economy and to address budget volatility. When asked whether this means he intends to support a sales tax on services, he stated, "I want to put everything on the table."

CALCHAMBER POSITION

The CalChamber, along with a large and diverse coalition of business interests, would strongly oppose legislation seeking to impose a tax on business services performed in California. This unnecessary tax increase would not solve California's budget volatility problem. Instead, it would result in higher prices for consumers and would increase the cost of doing business in this expensive state, hitting small businesses the hardest. California is facing record unemployment levels and small businesses are struggling to stay afloat. Now is not the time to saddle this state with more taxes.

Staff Contact
Preston Young
Policy Advocate

preston.young@calchamber.com
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