Tax on Business Services

Fails to Solve State Budget Volatility; Hurts Small Firms the Most

A service tax sounds simple and straightforward—just applying the existing state sales tax on goods to taxes on services. Depending on the scope of the services taxed, it could include services provided by attorneys, accountants, architects, advertisers, and art teachers—and that's only the A's! But, as with any new tax policy, the issues are never that simple.

California's tax system generates enormous revenue growth for state programs during good times. Since the end of the Great Recession, the state General Fund has increased by 60%, with per pupil school funding up by 66%.

Yet, because this powerful revenue machine is driven largely by taxes on upper-income taxpayers, it is vulnerable to a breakdown when the economy slows. Known as budget volatility, this same engine created a budget shortfall of $26 billion during the height of the recession in 2011.

Many legislators, and even Governor Arnold Schwarzenegger, have attempted to address budget volatility by suggesting changes to the tax system. Most recently, in 2018, Senator Bob Hertzberg (D-Van Nuys) introduced SB 993 to levy a tax on services purchased by businesses.

ADDRESSING STATE BUDGET VOLATILITY

The most important factor in considering volatility is whether and how much to reduce the most volatile tax—the personal income tax on wealthy individuals. The nature of the replacement tax is of secondary importance. Reducing the upper brackets of the personal income tax faces two obstacles: legal and political.

The top income tax brackets were placed in the California Constitution by Proposition 30 in 2012, and re-upped by Proposition 55 in 2016. They will not expire until 2031. Because these brackets are in the Constitution, they cannot be reduced or repealed without another statewide vote of the people, no matter the desires of the Legislature—which leads to the second obstacle:

The most popular taxes are taxes somebody else pays—which explains the success of voter initiatives levying taxes on high-wealth individuals (not to mention other statewide taxes on smokers and on a targeted subset of out-of-state corporations). No examples exist of voters approving a measure to replace a targeted tax on a few individuals with a general tax on themselves.

RECENT LEGISLATION

Over the last five years, Senator Hertzberg has introduced four bills to impose a sales tax on services in the state of California. The first three bills merely contained language describing the author's intent to tax all services (with a few exceptions) in order to modernize California's tax structure so that the state could curtail its infamous budget volatility. Not surprisingly, Californians were not excited about the prospect of paying taxes on their haircuts or their trips to the movies, and so much more. This proposal has been pejoratively dubbed the "Yoga Tax," and these first three bills did not advance far enough to receive a committee hearing, nor did they receive any substantive amendments to progress beyond intent language.

In 2018, Senator Hertzberg tried a different approach with the introduction of SB 993. Rather than continuing to attempt to tax *all* services, which is widely unpopular with voters in this expensive state, Senator Hertzberg focused SB 993 on taxing only services *paid for by businesses.*

Although some may view this targeted tax to be more politically expedient, it turns out that California voters are not too keen on this idea either. A statewide voter survey by the California Chamber of Commerce after the November 2018 election found that voters by a 3 to 1 margin oppose new taxes on services like lawyers, lawn care, or automotive repair—even if applied only to businesses.

SB 993, labeled a job killer by CalChamber, 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

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• Required sellers of business services to collect the tax at the time of sale if the benefit of the service was received in California.

Senator Hertzberg's proposal to offset the increased services tax with a decrease in the sales tax on goods was an odd choice, at best. The sales tax on goods rises and falls generally with the health of the economy. People buy more cars when times are good, and vice versa. But many items, such as clothes, alcoholic beverages, and household goods, are less affected by the business cycle.

On the other hand, many business services are vulnerable to economic ups-and-downs, such as legal and other professional services, architecture and design, and other services related to business sectors sensitive to the business cycle. By replacing a tax on goods with a tax on services, Senator Hertzberg's proposal could, in fact, increase budget volatility.

ANTICIPATED LEGISLATION IN 2019

Senator Hertzberg has already stated his intent to reintroduce the language of SB 993—or something similar to it—in 2019. Moreover, incoming 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."

POLICY CONCERNS WITH TAX ON BUSINESS SERVICES

• A targeted tax on business services will not solve California's budget volatility, which stems from our state's reliance on the personal income taxes of the highest income earners.

• Taxing most of the services used by businesses, including those necessary for day-to-day operations, like accounting, janitorial services, or landscaping, would increase the cost of doing business in an already-costly state. This could lead to companies cutting employee wages and hours or downsizing operations in California.

• A tax on business services will increase the cost of producing and selling goods here 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 the higher prices having a disproportionate impact on working families.

• It would make an already-complex tax system even more costly and challenging for California businesses to navigate.

• Small business would be hit the hardest. Although SB 993 had a limited exemption from this tax increase for certain small businesses, it certainly did not protect all of them. Small businesses depend on business services to conduct their operations. While larger businesses will be able to avoid paying taxes on certain services by bringing them in house, most small businesses will not be able to do so.

• The burden of complying with this new tax will 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.

• A tax on business services will unquestionably put California businesses at a competitive disadvantage. For businesses that must purchase services, a 3% tax on business services has no counterpart among the vast majority of other states. California companies would need to increase prices, reduce expenses, or perhaps relocate, to accommodate this new burden. If adopted, any other state in the country would have a more business-friendly tax environment than California and lower prices for the services covered.

• Finally, there is no need to raise taxes on businesses. According to a November 2018 report by the Legislative Analyst's Office, revenue is at an all-time high and surplus reserves in the state's rainy day fund are expected to hit full funding.

CALCHAMBER POSITION

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.

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