Sales Taxation of Services: Issues and Options for Colorado

Presentation to the Task Force Concerning Tax Policy

Michael Mazerov, Senior Fellow
State Fiscal Policy Division, CBPP
mazerov@cbpp.org
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Expanding the sales tax to services

- Single biggest structural flaw of state sales taxes is very spotty coverage of services
- Some recent progress, but way too slow
- Why tax services?
  - Improve sales tax fairness
  - Substantial immediate revenue potential
  - Long-term fiscal sustainability/elasticity

Why tax services? Fairer sales tax

- "Horizontal" equity principle: similar tax treatment of similarly-situated taxpayers
- Failure to tax services unfair to people who simply prefer to spend their money on goods
- Many untaxed services are close substitutes for taxable goods
  - Lawnmower taxed; lawn service exempt
  - Software purchase taxed; software subscription exempt

Does taxing services make sales tax less regressive?

- Conventional wisdom says yes, but best (old, limited) empirical evidence says no
- Why? Lower-income people must spend significant share of their incomes on services (hair cuts, car repairs, plumbing repairs)
- Sales tax <u>could</u> be extended to services primarily bought by affluent, but would generate relatively little $

Broadly taxing services would make <u>overall</u> tax system <u>more</u> regressive

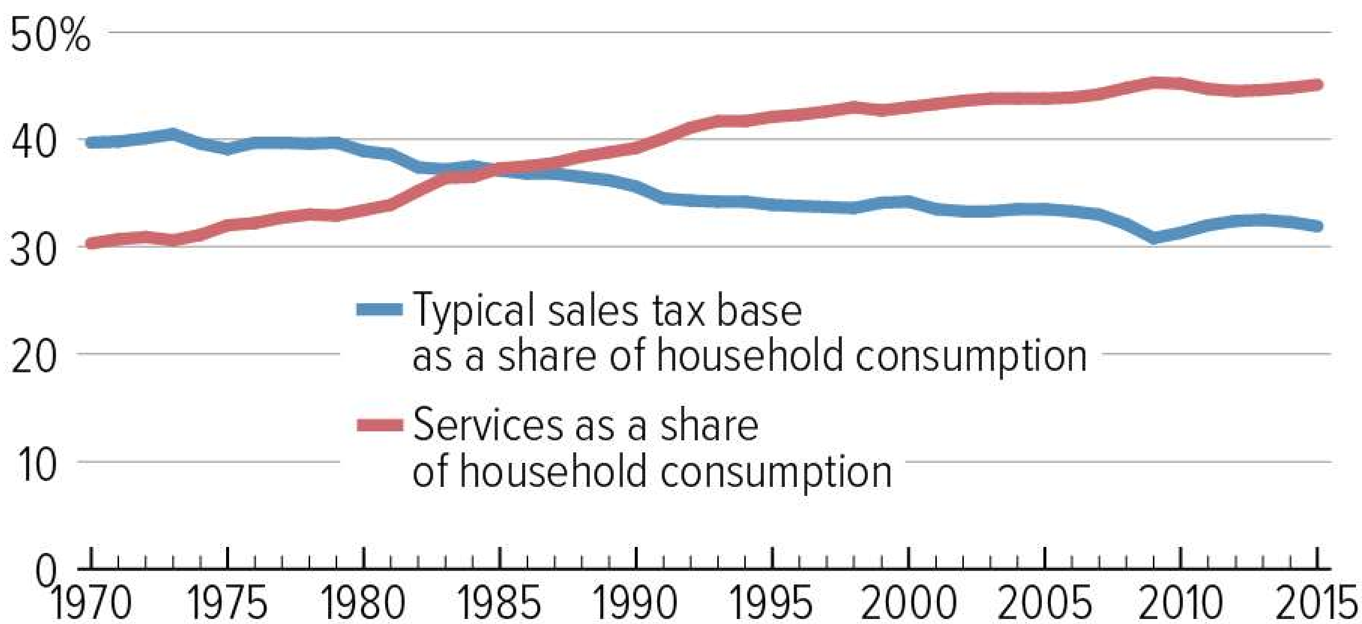
- Broad expansion to services coupled with completely offsetting rate cut will <u>not</u> make sales tax <u>itself</u> significantly more <u>or</u> less regressive
- But generating net additional revenue from sales tax will increase regressivity of <u>overall</u> tax system because of greater reliance on <u>inherently</u> regressive tax
- Any significant increase in <u>net</u> sales tax revenue from taxing services therefore should be significantly offset for low-income people, e.g., via expanded EITC or refundable sales tax credit
- Services shouldn't be taxed to finance income tax cuts!

Why tax services? Revenue

- Revenue potential from comprehensive expansion to household services is substantial (even minus health care, childcare, education, and residential rentals, which shouldn’t – and won’t – be taxed)
- States like Colorado, with little current taxation of services, could probably boost sales tax revenue 25%-35%

Why tax services? Long-term fiscal stability

Service Sector Growth Erodes Sales Tax Base



Note: Sales tax base includes durable and non-durable goods. Food and beverage purchased for off-premise consumptions are excluded, since most states exempt these purchases from taxation, while food services are included since these are usually taxed. Services include all services except housing and food service.

Source: Bureau of Economic Analysis

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Why tax services? Long-term fiscal sustainability

- Household consumption shifting from goods to services (despite contrary experience early in pandemic)
- Results:
  - ➢ failure of sales tax revenue to grow as rapidly as cost of services sales tax is supposed to pay for
  - ➢ steady increase in sales tax rates to compensate
- Need to mitigate these effects is arguably most important reason to expand base to include more services

What services should states tax?

- Services that are primarily business-to-business (e.g., payroll processing) should not be targeted for new taxes
- Focus on untaxed household purchases (e.g., personal trainers)
- Services frequently sold to both households and businesses (e.g., auto repair) should be taxed
    - Substantial evasion potential given large number of self-employed people who could claim personal consumption (telephone, car repair, hotels) was for business purpose
    - Unreasonable burden on seller/government to police eligibility for business purchase exemption

Problems with taxing business purchases

- Principles: sales tax is supposed to be tax on final consumption
- Pyramiding: double-taxation of business inputs
- Passthrough: tax on inputs passed-through to purchasers, increasing regressivity
- Politics: fierce business opposition

Taxing business services: pyramiding

- Sales tax is 10%
- Business buys $500 of taxable services
- Has $50 sales tax expense ($500 * 10%)
- Has $350 in labor costs
- Business charges $1000 for its service to:
  - recover $50 in sales tax costs
  - recover $850 in services and labor expenses
  - obtain $100 profit
- Customers charged $100 on receipts ($1000*10%) plus $50 in hidden tax on services, i.e. 15% sales tax, not 10%

Problems with pyramiding

- No transparency; part of tax is hidden in price
- Increased regressivity: hidden tax in price of items that were exempted to mitigate regressivity (e.g., sales tax on supermarket's electricity hidden in price of groceries)
- Sellers may lose business to competitors in other states where price is cheaper because inputs are tax-exempt
- Creates incentive to provide services in-house with employees (e.g., janitorial) rather than outsource to more efficient suppliers (many of which would likely be small businesses)

Taxing business purchases: politics

- Business goes ballistic when expanded taxation of B2B services proposed
- Not a great track record; major expansions to business services in FL, MA, and MI repealed
- Recent expansions to data processing services quickly repealed in MD, MA, CT
- Trend has been toward exempting <u>more</u> business purchases

Business community exaggerates problems with sales taxation of business inputs

- Substantial portions of final household consumption are not subject to sales tax; e.g., food for home consumption, residential rentals, health care, airfares, Internet access, private school/college tuitions

- If business purchases to provide those goods/services are subject to tax but final consumption isn't, there's no pyramiding

- Likewise, if sales taxes on such inputs are passed through to consumer in sales price of tax-exempt item (e.g., sales tax imposed on janitorial service in rental apt. bldg.), those taxes effectively are an appropriate tax only on final consumption

What household services could states tax?

Lawn and garden	Pet-related (grooming)
Personal transportation	Storage and moving
Residential utility	Telecommunications
Financial and insurance	Personal care (haircuts)
Misc. personal (party planners)	Home cleaning/maintenance
Clothing-related (dry cleaning)	Education-related (piano lessons)
Other professional (legal)	Admissions/recreation
Vehicle repair/maintenance	Residence construction/repair
Housing and real-estate	Misc. repair/installation

“Lay of the land” in taxing household services

- Virtually all states tax restaurant meals, physical property rentals (e.g., tools, tables), hotel rooms
- HI, NM, SD tax virtually all services except health care
- Taxation of services in other 42 sales tax states more extensive than often thought
- But of 60 (primarily) household services in FTA survey, only 7 were taxed by at least 30 states

Approaches to expanded taxation

- Comprehensive (HI, NM, SD only)
  - All services defined as taxable unless explicitly exempt
  - Mirrors taxation of tangible personal property
- Incremental
  - State enumerates additional services subject to tax
  - “Sale at retail includes [list of services].”

Pros/cons of comprehensive taxation approach

- Pros:
  - Big revenue gain
  - No need to update law as new services invented
  - Reduces line-drawing and similar issues
- Cons:
  - Brings thousands of new retailers into tax system immediately
  - Despite best effort to develop exemptions, likely to encompass many B2B services

Pros/cons of <u>incremental</u> taxation approach

- Pros:
  - Inherently requires deliberate consideration of which services state is trying to tax
  - Permits balancing of distributional effects, administrative issues, likelihood of evasion, revenue yield, etc.
- Cons:
  - Political: selected services will claim unfair targeting
  - Revenue gains may be modest
  - Difficult to write water-tight definitions of taxable services
  - Newly-invented services get free ride

Comprehensive vs. incremental approach: the past and the future

- Incremental approach likely will dominate
- Political sweet spot? Not too many new services at one time; not too few
- No sugar-coating it: <u>any</u> base expansion is politically <u>tough</u> (path of least resistance is to increase tax rate)
- Organized service retailer business interests likely to oppose
- Dangerous new development: Realtor-sponsored, voter-approved Arizona and Missouri constitutional amendments banned future expansion to new services