



Discussion Brief: Extending the Retail Sales Tax to Services in Washington

The state retail sales tax applies to purchases of materials and property and to some services, including construction services, property rental, landscaping, and dating services. Many services are exempt, including professional services such as accounting and engineering; business services such as janitorial and advertising; and personal or consumer services, such as cable TV and beauty and barber services. Expanding retail sales taxes to include business services is highly controversial even though substantial revenue can be raised. This discussion brief outlines the revenue impact and issues involved in eliminating exemptions to the retail sales tax.

Summary

- Most professional, business, and financial services and many consumer services are exempt from sales tax. The Department of Revenue estimates that extending retail sales tax to all services could raise \$2 billion annually.
- 5 categories of business and professional services (advertising, computer/data processing, misc. business services/consulting, legal, engineering/architectural) together could raise \$714 million annually.
- Retail sales tax has been added over the years to services performed on tangible personal property (such as auto repair), construction services, and some other selected services (such as landscape maintenance and tour operators).
- Services are a growing sector of the economy.
- Taxes on services are not generally progressive, but tend to be less regressive than general sales taxes.
- Few states tax services, and attempts to impose new taxes on services have met with fierce resistance.
- If implemented without other changes to Washington's current B&O tax, taxes on professional and business services could result in tax pyramiding, and be detrimental to smaller businesses that rely on outside services.

Introduction

The retail sales tax in Washington is levied predominantly upon purchases of tangible personal property. For the most part, services in Washington have been exempt from the retail sales tax since the implementation of the sales tax in 1935. In 1935 services constituted a small portion of the economy. However, this has changed significantly as consumers continue to spend a larger proportion of their incomes on services rather than taxable retail items. In the future it may be important for the state to consider this growing segment of the economy in order to ensure the adequacy of future revenues.

Some service activities have been added to the retail sales tax base since 1935. In 1939 services performed on tangible personal property became subject to the tax. Construction services were added in 1941 and the rental of tangible property was added in 1959. More recently, selected services such as landscape maintenance, physical fitness, tour operators as well as tanning and dating services were added in 1993. Services not currently subject to the retail sales tax include professional services, (legal, accounting, architectural, engineering) business services, (advertising, employment agency, janitorial) personal or consumer services (cable TV, beauty and barber, veterinary, amusement and recreation) and financial services (banking, credit agencies, security brokers).

Other States

There are very few states that impose sales taxes upon services. Attempts to extend the sales tax base to cover services are usually met by fierce opposition. New Mexico levies what appears to be a 5% sales tax upon services; however, the New Mexico tax is actually levied on businesses' gross receipts. The tax resembles a sales tax in that in almost every case the business passes the tax on to the consumer. Hawaii and South Dakota also levy taxes upon services, but these states also implement the tax as a tax on businesses' gross receipts. States with tax structures more similar to Washington that also have experience with levying a tax on services include Texas and Florida. Texas currently taxes a wide range of services including amusement services, (e.g. sporting events, health clubs, golf courses etc.) cable TV services, insurance services, and various personal services (laundry, dry cleaning, carpet cleaning etc). The state of Florida implemented a major expansion of its sales tax to include services in 1987, but the policy was quickly repealed after being in effect for 6 months. Observers of the 1987 Florida policy cite antitax campaign rhetoric in the 1988 election in combination with a concerted opposition effort by the media (who were aggravated by the inclusion of the tax on advertising services) as factors for the swift repeal. Earlier this year there was an effort by the Florida State Senate to again implement the state sales tax on services, but this has since been scaled back to be a constitutional amendment proposal to form a committee with the power to repeal certain sales tax exemptions.

Potential Revenue

For fiscal year 2003, the department of revenue estimates that implementing the retail sales tax upon business, professional, consumer and financial services could raise around \$2 billion. The following table provides a more detailed breakdown of the amounts by specific business activity.

Equity/Regressivity

It is assumed by many that higher income individuals spend relatively more of their incomes on services, particularly professional and business services. Under this assumption it is easy to surmise that extending the sales tax to services would make the tax system more progressive. However, the sparse amount of research that exists on the subject indicates that extending the sales tax to services is proportional at best, or slightly regressive, depending on the services that are included in the tax. In 1987, Florida temporarily extended its 5% sales tax to a broad range of services such as legal, accounting, advertising and construction services. Overall, extending the sales tax to services in Florida was estimated to be slightly less regressive than the 1% increase in the general sales tax on commodities that replaced it¹. A recent study from

Nebraska finds that the regressivity of Nebraska's tax system would not be improved by adding services (excluding personal and medical services) to Nebraska's existing tax base².

Sales Tax on Services: Revenue Potential

BUSINESS and PROFESSIONAL SERVICES	Millions (state) FY 03	PERSONAL or CONSUMER SERVICES	Millions (state) FY 03
		Laundry, Cleaning	4.27
		Beauty/Barber Shops	22.49
		Funeral Service	5.59
Crop Services	7.09	Misc. Personal Svcs.	13.94
Advertising	103.19	Veterinary	17.40
Collection Agencies	7.40	Cable TV	40.80
Addressing/Mailing/Steno.	11.42	Motion Pictures	12.07
Janitorial Services	14.77	Amusement & Recreation	91.93
Employment Agencies	22.67	Other Services	114.98
Computer/Data Processing	129.36	Total Consumer	323.46
Misc. Bus. Svcs., Consulting	266.02		
Railroad Services	13.20		
Boat Services	4.34		
Tour Packages	2.07		
Loading	3.34	FINANCE, ins.& real estate	Millions (state) FY 03
Legal Services	105.66	Banking, Accts Receivable, Etc.	292.57
Engineering, Architectural	109.82	Credit Agencies	163.15
Accounting, Auditing	51.66	Credit unions (customers)	7.17
Media advertising	50.45	Security Brokers	60.96
Photographic Studios	7.11	Insurance Cos.	43.97
Automotive Services	8.39	Insurance agents	59.44
Miscellaneous Repair	2.90	Real Estate	78.89
Travel Agents	22.98	Holding, Investment	15.61
Other Business, Government	2.13	Total Financial	721.76
Total Business	945.98		

Source: Washington Department of Revenue

Other Issues

Taxing business services may have unintended consequences. For example, large vertically integrated businesses that are not as reliant on outside consulting services would have a clear advantage over smaller non-integrated businesses. This would tend to encourage firms to vertically integrate. In addition, taxing business services will further exacerbate the problem of tax pyramiding in Washington state. Similar to the B&O tax, which can tax a good multiple

times as it makes its way through the production process, adding the sales tax to services used predominantly by business can also lead to multiple taxation.

Extending the sales tax to include consumer services would require a statutory change so that consumer services would be defined as a retail sale. Redefining consumer services as a retail sale would also change the business classification so that these services would be subject to the 0.47% B&O retail rate instead of the current 1.5% B&O service rate. Even though the new B&O rate would be lower, there would still be a net gain in tax revenues because these services would be subject to the 6.5% sales tax rate.

¹ Siegfried, John J. and Paul A Smith. "The Distributional Effects of a Sales Tax on Services." *National Tax Journal* 44 No 1 41-53 (March 1991)

² O'Callaghan, Dority, "Is Nebraska's Sales Tax Becoming More Regressive?" *Bureau of Business Research* May 2002