Utah FOUNDATION RESEARCH BRIEF

Effects of Broadening the Sales Tax to Services

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Introduction

Last November, former Governor Olene Walker released a comprehensive proposal to reform Utah's tax structure to better meet the state's future needs. One of the featured recommendations in the proposal was to broaden the sales tax base to include services that are provided to personal consumers. The reasons for the recommendation were that broadening the sales tax base would take into account current economic trends as well as making the tax more balanced and fair by distributing the tax more broadly and allowing for a possible reduction in the sales tax rate. The proposal also stated that a reduction in the rate would lead to a less regressive tax because the poor would be taxed less for necessities. This research brief will explore the rationale behind the proposal to broaden the sales tax to include services and the issues surrounding the proposal.

Eroding Sales Tax Base

Revenue from sales taxes makes up the lion's share of the state General Fund (87.6% in 2003), which is used to fund general government activities and higher education. In Utah, the sales tax base is mainly derived from the sales of tangible goods, while most services are exempted. The exemption of services from the sales tax was originally not a conscious policy decision when the sales tax was first enacted in Utah in 1933, but rather a result of services being only a small fraction of consumer spending at the time. However, the state and national economy has vastly changed since then. Calculations based on the National Income and Products Accounts table on U.S. personal expenditures show that since 1980, household service expenditures have risen from 48.2% of personal consumption to 59.4%. During that same period, expenditures on tangible goods have fallen from 51.8% to 40.6%. This trend of personal consumption towards services is likely to continue, which will in turn further erode the current sales tax base in Utah.

According to economists Donald Bruce and William Fox at the University of Tennessee's Center for Business and Economic Research and M.H. Tuttle of Sam Houston State University, Utah's sales tax base is not keeping up with our economy. They estimated Utah's long run sales tax elasticity to be 0.873; meaning that for every 1% growth in personal income, sales tax revenue grows by only 0.873%. Bruce, et al. also estimated that Utah's short run sales tax elasticity was quite volatile. During economic expansions the short run elasticity was 1.780, meaning that the tax base expands faster than the economy. However, during economic downturns the short run elasticity was -1.544, indicating that the tax base was contracting more than the economy. The negative elasticity stems from the fact that personal income is almost always increasing, and that when personal income growth falls below expectations, revenue growth is negative. While this trend is acceptable when revenues exceed expectations, the state can often be unprepared for revenue shortfalls due to the lack of stability of revenues.

> "Elasticity:" An economic concept that measures the responsiveness (or sensitivity) of one variable to changes in another variable. For our purposes, we pose the question "how elastic (or sensitive) is revenue based on changes in income?" A number greater than one signals that the revenue is elastic or sensitive to changes in income. Less than one signifies an "inelastic" tax or one that is not as sensitive to income changes

Expanding the Sales Tax

Most states, including Utah, have partly broadened their sales tax base to include some services. However, only Hawaii, New Mexico, and South Dakota tax services comprehensively, and the Federation of Tax Administrators estimates that most states tax less than one-third of potentially-taxable service categories. According to a Federation of Tax Administrators 1997 survey on the sales taxation of services, Utah levied sales taxes on 22 of the 40 identified services purchased predominantly by households. Figure 1 lists the number of household services taxed by each state form the list of 40 major household services.

Figure 1: State Sales Taxation of Services Purchased Predominantly by Households

State	Number of Services Taxed	State	Number of Services Taxed	State	Number of Services Taxed
Alabama	9	Kentucky	6	Ohio	17
Arizona	18	Louisiana	20	Oklahoma	10
Arkansas	22	Maine	2	Pennsylvania	15
California	2	Maryland	8	Rhode Island	1
Colorado	2	Massachusetts	0	South Carolina	12
Connecticut	25	Michigan	4	South Dakota	40
District of Columbia	18	Minnesota	24	Tennessee	27
Florida	22	Missouri	11	Texas	24
Georgia	11	Nebraska	20	Utah	22
Hawaii	39	Nevada	2	Vermont	10
Idaho	10	New Jersey	27	Virginia	4
Illinois	3	New Mexico	39	Washington	21
Indiana	6	New York	23	West Virginia	37
Iowa	34	North Carolina	10	Wisconsin	29
Kansas	27	North Dakota	9		

Note: Figure 1 shows the extent to which states tax 40 services purchased predominantly by households identified by The Center on Budget and Policy Priorities from the Federation of Tax Administrators 1997 survey of State Taxation of Services. Figure 1 is not a complete representation of states' taxation of all available services, but of those that are mainly purchased by personal consumers.

Source: Federation of Tax Administrators; calculations by Center on Budget and Policy Priorities

One of the major arguments for expanding the sales tax to include services is the revenue potential from the extension. A study by Michael Mazerov of the Center on Budget and Policy Priorities calculates the revenue potential of expanding the sales tax to household services to be an increase of 23% of current revenues. However, those calculations do not account for the fact that Utah already taxes some household services. Governor Walker's proposal stated that if tax changes were revenue neutral, the state sales tax could be reduced to as low as 3.75%. In addition to increasing revenues or reducing the sales tax rate, expanding the sales tax would prevent a continued erosion of the tax base by capturing the shift of consumption to services.

While only a limited comparison, the Bruce, et al. study found that the states that tax services comprehensively (Hawaii, New Mexico, and South Dakota) had higher long run tax elasticities than Utah (Figure 2). A comparison of state sales tax revenues as a percent of personal income seems to corroborate this finding (Figure 3). The trendlines on the graphs for each state indicate that Utah's sales tax revenues as a percent of personal income are declining relatively quickly. New Mexico and South Dakota experience slightly upward facing trendlines, while Hawaii has experienced a slight decline, which may be attributed to Hawaii's long running economic recession in the 1990s.

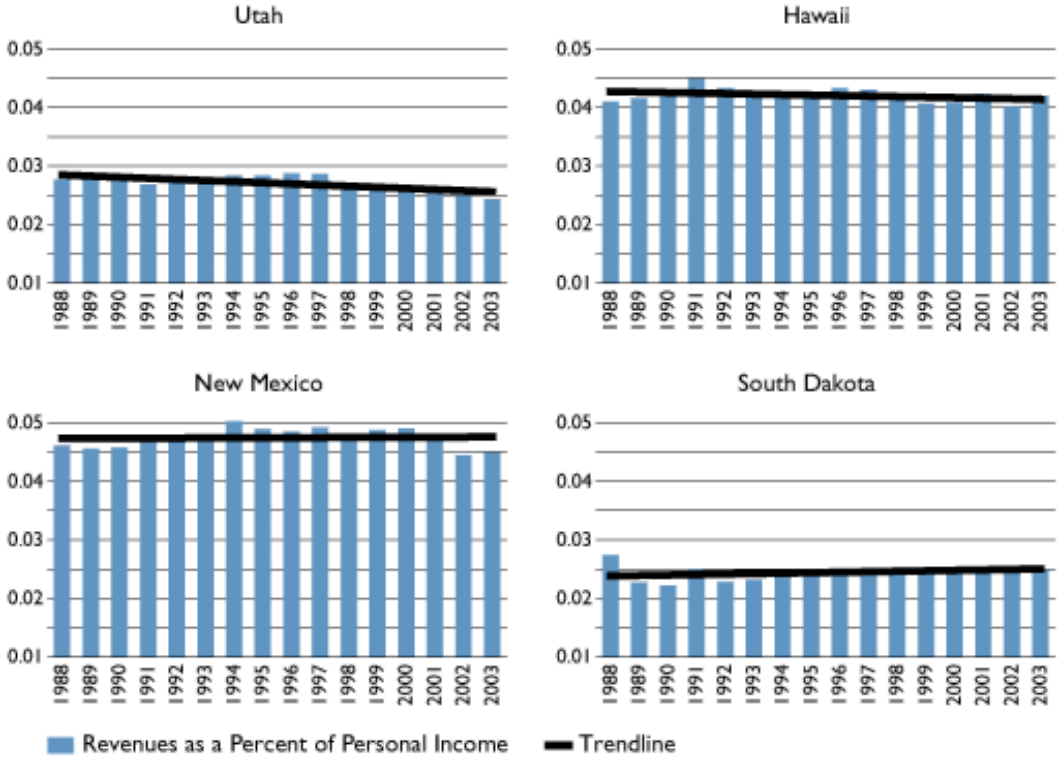
Figure 2: State Sales Tax Elasticities

State	Long Run Elasticity	Short Run Elasticity: Below Equilibrium	Short Run Elasticity: Above Equilibrium	State	Long Run Elasticity	Short Run Elasticity: Below Equilibrium	Short Run Elasticity: Above Equilibrium
Alabama	0.712	0.05	1.12	Nebraska	0.431	0.191	18.779
Arizona	0.744	-1.232	1.452	Nevada	0.781	-0.5	1.6
Arkansas	0.835	0.323	1.398	New Jersey	1.049	-0.297	1.552
California	0.833	-1.408	1.146	New Mexico*	0.924	-0.628	3.07
Colorado	0.781	1.869	1.869	New York	0.75	0.128	1.571
Connecticut	1.242	1.152	2.781	North Carolina	0.874	0.501	1.82
Florida	0.926	-0.049	1.445	North Dakota	0.339	0.256	-0.506
Georgia	0.708	0.171	1.209	Ohio	1.033	1.802	1.802
Hawaii*	1.11	0.629	1.285	Oklahoma	0.695	1.89	1.89
Idaho	0.847	0.665	1.456	Pennsylvania	1.069	1.504	1.504
Illinois	0.871	0.028	0.028	Rhode Island	0.531	0.515	1.848
Indiana	—	0.723	0.723	South Carolina	0.773	-1.15	1.143
Iowa	0.374	-0.056	0.853	South Dakota*	1.145	0.471	0.471
Kentucky	0.654	0.826	0.826	Tennessee	0.716	0.308	1.271
Kansas	0.63	0.466	0.466	Texas	0.997	1.58	1.58
Louisiana	0.514	-0.347	1.531	Utah	0.873	-1.544	1.78
Maine	0.904	-0.857	1.047	Virginia	0.8	-0.645	0.826
Maryland	0.767	1.162	1.162	Vermont	0.735	0.779	2.289
Massachusetts	1.365	0.354	2.375	Washington	0.74	0.045	1.722
Michigan	0.772	-0.017	1.713	West Virginia	1.013	-1.146	3.295
Minnesota	0.876	-0.226	0.903	Wisconsin	1.113	-0.623	1.373
Mississippi	0.486	-0.188	1.34	Wyoming	0.72	1.443	1.443
Missouri	0.639	-2.192	0.907				

*States that tax services comprehensively

Source: Bruce, Donald, William F. Fox and M.H. Tuttle. 2004. "Tax Base Elasticities: A Multi State Analysis of Long-run and Short-run Dynamics" Table 3: "Sales Tax Elasticities."

Figure 3: Comparison of State Sales Tax Revenues as a Percent of Personal Income



Source: Individual State Departments of Revenue; Bureau of Economic Analysis; Calculations by Utah Foundation

According to Kirk J. Stark in an article for State Tax Notes Magazine, including services in the sales tax could have the effect of stabilizing tax revenue. This claim is based on the assumption that services are less prone to the cyclical nature of the economy, therefore mitigating the revenue shortfalls during economic downturns. As explained above, Utah is particularly vulnerable during economic downturns and a comparison of short term elasticities (Figure 2) indicates that states that tax services comprehensively are less prone to revenue shortfalls.

Efficiency & Fairness

In principle, the sales tax is intended to be a tax on household consumption. However, as the number of services being offered in our economy has increased, so has the variability in the amount of sales tax that households pay within similar levels of consumption. Households that prefer to spend their disposable income on goods can end up paying a greater amount of taxes than those that choose to devote a similar amount of disposable income to services. Also the number of services that can act as close substitutes for tangible goods has been steadily increasing, and so if prices are similar, consumers will avoid the tax by opting for the service. Therefore, broadening the base to include services will distribute the tax burden more fairly, regardless of consumption preferences.

The sales tax is generally regressive in relation to taxpayers' income because low-income households tend to consume a larger percentage of their income than those with higher incomes and also because low-income households relatively consume more goods and less services than higher-income households. Some proponents of an extension of the sales tax say that broadening the tax base would significantly lessen the regressivity of the sales tax. The regressivity would be reduced because broadening the base will allow for a reduction of the overall sales tax rate and thereby reduce the amount of tax paid on necessary items such as food. However, the research that has been conducted on this topic does not seem to indicate that extending sales taxes to services significantly reduces regressivity. A 1990 study by Minnesota House of Representatives economists found that consumption of certain services, such as water, sewer and personal care, comprised a higher percentage of expenditures for those with low-incomes. Nevertheless, this study and others by the Institute of Taxation and Economic Policy and Vanderbuilt University found that expanding the sales tax is unlikely to make the sales tax more regressive, and even may slightly reduce regressivity.

This research brief was written by Research Analyst Richard Pak with assistance from Executive Director Steve Kroes. Mr. Pak and Mr. Kroes may be reached for comment at (801) 355-1400. They may also be contacted by email at rich@utahfoundation.org or steve@utahfoundation.org. For more information about Utah Foundation, please visit our website: www.utahfoundation.org.
