



INCREMENTAL STEPS TOWARD TAX REFORM: DISCUSSION BRIEF #2

Expanding Washington’s Sales Tax Base

The problem: Washington is facing a budget shortfall in 2009 due to rising prices and the national economic downturn. Without new sources of revenue, Washington will have to cut essential services even while demand increases. We will also be forced to postpone important new investments to improve education, public health, and transportation. In addition, Washington suffers from an outmoded and regressive tax structure. State and local taxes fall too heavily on low- and middle-income residents, and public revenues grow more slowly than the need for public investments.

A step in the right direction: Extending the sales tax to selected goods and services may be the simplest way to expand Washington’s tax base, both raising new revenue and strengthening the tax structure. *Including the items listed in this brief in the sales tax base would provide up to \$784 million in additional state revenue and \$293 million to local governments in the 2009-11 biennium.*

Sales tax: Washington applies a 6.5% tax to the sale of most goods and a few services, providing over half the state’s general fund revenue. Local governments add another 0.5% to 2.4%. Heavy reliance on sales tax is a major factor in the regressivity of Washington’s tax system, since low- and moderate-income people spend a higher percentage of their income on items subject to sales tax than the wealthy do. Over-reliance on sales tax also contributes to the gap between revenues and demand for services, because Americans spend less of their income on items subject to sales tax than in the past.¹

SUGGESTED EXPANSIONS OF WASHINGTON’S SALES TAX BASE

	# of states that tax	2009-11 biennium	
		State revenue	Local revenue
Candy and gum ^a	29	\$61.3 million	\$19.8 million
Consumer services ^a	varies ²	\$255.2 million	\$98million
Detective & security services ^a	14	\$108.7 million	\$41.7 million
Janitorial services ^a	17	\$10.9 million	\$4.2 million
Custom software ^b	28	\$220.3 million	\$80.5 million
Securities brokers ^a	<i>not avail.</i>	\$128 million	\$49.1 million
Total		\$784.4 million	\$293.3 million

Sources: ^a Washington Department of Revenue, July 2008.

^b Washington Department of Revenue, Tax Exemptions 2008.

Candy - The general exemption of food from the sales tax lessens the regressivity of the overall tax system. But candy is hardly a necessary food item and contributes to the obesity epidemic that is undermining public and children’s health. At latest count, 29 states apply sales tax to candy.³

Services - Taxing consumer services adds fairness. There is no rationale for charging sales tax on movie rentals but not theater tickets, for pet grooming supplies but not pet grooming services, for hair dye and razors but not hair salon services. Services are also more likely to be purchased by higher-income households.

Washington, like most states, is less likely to apply sales tax to services than to goods. Washington's sales tax currently applies to most repair and construction services, but not to a whole host of other consumer, business, professional, medical, and financial services.

Just about every service is subject to sales tax in some state. A handful of business services are particularly likely to be taxed.⁴ These include janitorial and security services, which are site-specific and relatively easily taxed in the same way that repair and construction services are. A majority of states also apply sales tax to customizing software. This might be politically difficult in Washington given the prominence of the software industry. Taxing other professional, financial, and medical services potentially raises a great deal of revenue, but there are policy and technical reasons to avoid them.⁵ Rather than applying sales tax to lawyers or architects, for example, it would be much simpler to raise their B&O tax rate.

Extending sales tax to select services would result in a big tax cut for the affected businesses, because their B&O tax rate would change from the 1.5% services rate to the 0.471% retail rate.

Conclusion: Sales tax is the backbone of Washington's revenue system. Simply raising the sales tax rate to gain revenue will only compound regressivity and the long-term lag in revenues. In contrast, expanding the base moves us toward a system better aligned with the 21st century economy.

¹ Between 1959 and 2000, the share of household spending on services increased from 40% to 58%. Larry R. Moran and Clinton P. McCully, "Trends in Consumer Spending, 1959-2000," *Survey of Current Business* (2001): pp. 15-21, U.S. Bureau of Economic Analysis, <https://www.bea.gov/scb/pdf/national/nipa/2001/0301pce.pdf>.

² For example, 5 tax barber and beauty salons, 18 coin operated video games, 23 membership fees, and 24 tax cable and satellite TV. Federation of Tax Administrators, *2004 Service Taxation Survey*, www.taxadmin.org.

³ Fifteen states tax candy along with all food; 14 exempt food, but not candy. FTA, "State Sales Tax Rates and Food & Drug Exemptions," February 2007, www.taxadmin.org; National Confectioners Association, "State Sales Tax & Treatment of Confectionery," August 2003, <http://www.ntconcepts.com/>. The Streamlined Sales Tax Agreement which Washington has entered into allows candy to be taxed while other food products are not. It also provides a standard definition of candy that retailers in other states are already following. See, for example, Iowa Grocers Association, "Streamlined Sales Tax Update: Several Baking Items Taxable Beginning January 1st," www.iowagrocers.com/index.cfm?page=60. Tennessee Department of Revenue, Sales and Use Tax on Candy, <http://www.state.tn.us/revenue/notices/sales/2002candy.pdf>.

⁴ Federation of Tax Administrators, *2004 Service Taxation Survey*, www.taxadmin.org.

⁵ The exemption of medical services is in keeping with the exemption of other basic necessities, food and prescription drugs. Applying sales tax to many professional services is technically difficult. Such services are often not fixed to a place or product, many firms span state and national borders, and services are both purchased and performed in-house, raising the issue of whether and how to apply use tax. Adding sales tax to business services also adds to the problem of pyramiding in the B&O tax – with businesses essentially paying tax on tax payments.