Morrison Institute for Public Policy

ARIZONA STATE UNIVERSITY

Taxing Services: Arizona's Untapped Revenue Resource

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As the state grapples with another year of what seems like insurmountable budget deficits, one possible solution is being ignored as an additional revenue source. Specifically, Arizona forgoes billions in potential sales tax dollars each year by not taxing most services, relying instead on sales tax applied to tangible goods.

Expanding sales tax to certain services would reflect the economic reality of how Arizonans spend much of their money, but legislative leaders are choosing to ignore the untapped revenue resource. As lawmakers look to overcome a nearly $2 billion shortfall for this year and next,[i] it is time for the conversation to include thoughtful and strategic revenue options. Expanding the sales tax to include certain services is one potential tool.

Where We Stand Today[ii]

Arizona's current budget situation is dire. Facing a shortfall of approximately $764 million for the remaining five months of the current fiscal year, and nearly $1.2 billion for FY 2012 beginning July 1, Governor Jan Brewer has put forward a proposed budget solution. Unfortunately, the proposal relies largely on gimmicks to address the current year – $650 million of the solution as either rollovers, new debt or additional sale/leaseback of state property – and cuts to balance 2012.

Specific reductions include:

- $170 million in state funding to universities
- $73 million reduction to community colleges
- $89 million cut in payments to current providers of Arizona Health Care Cost Containment System, the state's Medicaid program
- $542 million cut to AHCCCS, providing the federal government exempts Arizona from healthcare reform requirements

This last cut is a gamble, reliant on federal action. When federal health care reform passed last year, one requirement was that states had to maintain their current levels of Medicaid coverage. Arizona, as a result of voter action in the year 2000, covers individuals earning up to 100 percent of the federal poverty level, or $10,890 annually.

The governor is formally requesting the federal government waive Arizona from the requirements mandated on all states. There is no indication if this will be successful. If it is not, Arizona's elected leaders will have to address the remaining half-billion dollar hole some other way.

How Did We Get Here[iii]

There is no question the Great Recession has upended federal and individual states' budgets. Arizona was particularly hard hit, having been ground zero for the burst of the housing bubble. As a result, the cyclical deficit, caused by the ebbs and flows of economic activity, skyrocketed. But it also laid bare the state's structural deficit – the chronic deficit that occurs when revenue fails to grow in tandem with expenditures.

A recent analysis of Arizona's structural deficit found that during Arizona's years of positive and rapid growth, permanent tax cuts were made, totaling $2.9 billion when adjusted for inflation. These cuts, which seemed to make sense at the moment, resulted in an erosion of reliable, state revenue. When the downturn hit, the true impact of the cuts became clear.

Arizona is now on the edge of substantial program cuts that could permanently alter the government landscape for decades to come. Further, cuts to education, health care and other key sectors of the local economy threaten future economic vitality.

Taxing Consumer Services

When Arizona's founders conceived a state tax system, no one could have foreseen the transformation and eventual dominance of the service economy. In 2010, it is estimated service industries accounted for 80% of U.S economy.[iv] However, the bulk of Arizona's taxable goods are just that – goods.

Arizona is by no means alone it its hesitancy to extend sales tax to services. In the most recent survey of the states conducted by Federation of Tax Administrators, Arizona fell in the middle of the pack, with 55 services identified as taxed. At 160 services taxed in 2007, Hawaii utilized this potential revenue source more than any other state.[v]

Discussions on taxing services, and the potential benefit, are not new. From an ill-fated attempt in Florida more than 20 years ago, to numerous blue-ribbon panel recommendations, there is little to no momentum to tax services in most states. In Arizona, the Citizens' Finance Review Commission recommended extending sales tax to some services in the early 2000s.

Why Is It So Difficult to Tax Services?

First, most economists agree that it is very important that consumer, or personal services, form the base of any discussion of taxation. Taxing business-to-business services can actually cause what is known as

"pyramiding."[vi] This occurs when, through the provision of business services, taxes are passed between providers in the production of a service or good and end up creating a hidden cost of doing business. An example of this would be the manufacturer of a particular good paying taxes to its accountant and attorney through the course of doing business, then passing this expense along to consumers. One unintended consequence often identified with pyramiding is that businesses end up structuring themselves in a manner that is not focused on efficiency, but avoiding taxes.[vii]

Additionally, all policy choices, especially those related to taxation, do not occur in a vacuum. There are political considerations and there are few elected officials eager to be known as the face of raising taxes during the most substantial economic downturn since the Great Depression. In fact, fears over taxing services reach much further back than the economic collapse of recent memory. In the 1980s, Florida expanded its sales tax to include most services. However, due to intense response, the taxes were repealed not long after becoming law, with then-Governor Bob Martinez losing his re-election bid as a result.[viii]

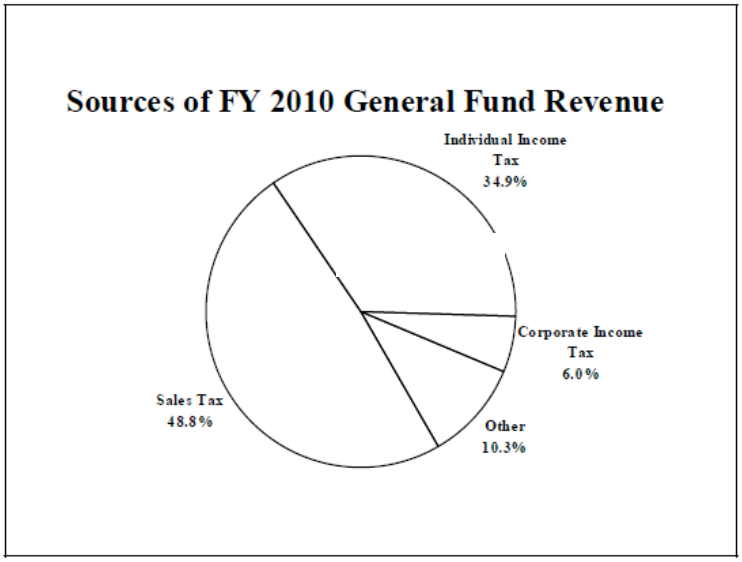
However, if ever Arizonans faced a time where necessity should drive invention, this is it. Further, expanding the tax to consumer services would not only provide critical revenue, it would also more accurately reflect the current economy and increase predictability and responsiveness of the tax system — two key components of successful revenue systems.[ix]

How Much Potential Revenue Could Arizona Generate?

Arizona relies heavily on sales tax to feed the General Fund. The Joint Legislative Budget Committee (JLBC), the budget staff for the Legislature, reports that nearly half of General Fund revenue is generated from sales tax.

In January 2010, Morrison Institute for Public Policy examined how much potential revenue the state could realize if services were taxed. At that time, the Department of Revenue (DOR) estimated revenues in excess of $2 billion were lost due to exemptions is service categories including health care, personal care and education.

Updated figures of forgone revenue are provided on the next page with DOR reporting a total of $3.3 billion of potential tax revenue available from all these sources combined.



Source: JLBC

Arizona Department of Revenue estimated revenue for service sales tax

Service[x]	Tax Revenue
Professional, scientific and technical (legal, architecture and engineering)	$933,100,000
Health care (physicians, dentists, chiropractors)	$875,600,000
Administrative and business support (employment placement and office administration)	$861,330,000
Personal care (barbers, beauty salons, nail salons, dry cleaners)	$71,890,000
Educational (technical and trade schools, education support services)	$48,740,000
Finance (mortgage loan brokers, investment advice)	$340,820,000
Other services (auto repair and maintenance, data processing)	$198,590,000
Total	**$3,330,070,000**

It is critical to realize that not all of these categories may be ideal candidates for taxation in light of the negative impacts of business-to-business service taxation. However, what is apparent is that there are untapped revenue resources that could provide direly needed investment dollars.

Conclusion

It is important to understand extending taxation to services is only one part of the state's entire revenue system, with the emphasis on "system."[xi] Arizona needs to examine its revenue system in totality to ensure it is predictable, efficient, competitive and equitable. However, as we face a budget cliff, it is time that policymakers begin discussing solutions that include revenue, in all its forms, and not just cuts.

Taxing services is one potential option to protect basic Medicaid coverage for 280,000 Arizonans or prevent devastating cuts to Arizona's educational system. It is time Arizona voters and lawmakers have the necessary discussion about alternatives. The prospect of taxing services is a good policy option to open the dialogue.

Sources

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[viii] *Ibid.*
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