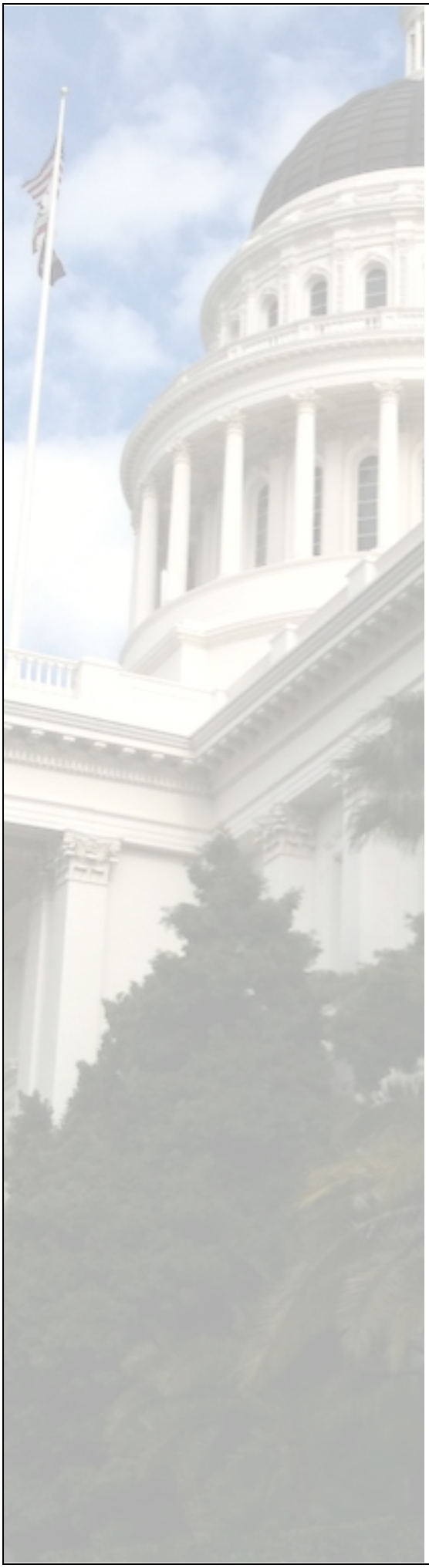

Sales Taxes on Services & Inflation in California

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EXECUTIVE SUMMARY – SALES TAXES ON SERVICES, INFLATION, AND THE CALIFORNIA ECONOMY

The State of California celebrated a record budget surplus in 2022; however in 2024 it finds itself in the midst of a severe fiscal situation. The Governor's Office announced in the May Revise that the State faces a $27.6 billion deficit in the 2024-25 fiscal year (excluding $17.3 billion of early budget actions) as well as a $28.4 billion deficit in 2025-26.

Some have called for the State to solve its ongoing boom-and-bust budget cycles by enacting a sales and use tax on services. A broader sales tax that includes services, the argument goes, should generate a large and stable source of revenue that would eliminate California's budget volatility.

In 2019 when Sen. Robert Hertzberg introduced Senate Bill (SB) 522, which would have imposed a sales tax on a range of "business services" in California, Encina Advisors analyzed the ramifications of such a services tax and issued a comprehensive report. This whitepaper, the second in a series, revisits our 2019 report and updates the analysis on sales taxes on services and California's economic environment. It addresses the hidden costs that a sales tax on services would impose on businesses and governments across California beyond the tax itself, particularly in the aftermath of record-high inflation.

Inherent Problems with Sales Taxes on Services

While some see a sales tax on services as an innocuous way to raise revenue for state government, imposing such a tax actually generates a number of problems. A sales tax on services:

- *Compounds Cost Increases.* Through "pyramiding," the same services are taxed multiple times as they move through production to final retail sale. This means the effective tax rate faced by customers grows beyond what was intended by statute.
- *Creates an Uneven Playing Field for California Companies.* More expensive inputs in California puts the state's companies at a disadvantage by artificially raising their cost structures relative to firms in other states.
- *Impacts Small Businesses Disproportionately*. Large companies have the resources to house many business services internally and circumvent the sales tax for these services, whereas small businesses are resource constrained.

- *Increases Costs for Consumers.* Even a narrowly tailored sales tax on just business services would increase costs for consumers because goods and services that people rely on daily depend on business services in their production.
- *Represents a Tax on Labor.* Service industries tend to be labor-intensive, and as a consequence, a sales tax on services would be expected to increase unemployment in the state.
- *Requires Significant Implementation Costs*. Thousands of businesses would incur additional administrative costs to register with the California Department of Tax and Fee Administration (CDTFA) and report and regularly remit their sales tax payments, while the CDTFA would need to hire hundreds of new workers.

Inflation and Services

Milton Friedman referred to inflation as "taxation without legislation," and since the initial publication of our report in 2019, the United States suffered a bout of record-high inflation. While inflation subsequently has moderated, the damage has already been done—from 2019 to 2024, prices for services increased by about 25.3 percent in the Los Angeles region and by approximately 26.1 percent in the San Francisco region. This means that a potential sales tax on services would only compound the substantial price hikes that California consumers and businesses already have been experiencing.

Impacts to the California Economy

We updated four brief case studies from our 2019 report to illustrate the implications that a sales tax on services would have on different California industries, adjusted for inflation. We found that instituting such a tax would create ripples of cost increases across the California economy, affecting business, consumers and government. The case studies comprise residential housing construction, K-12 school construction, SB 1 and transportation infrastructure, and small business.

We found, for example, that a 5 percent sales tax on services would add nearly $21,000 to the price of a new home, a 3 percent increase. A 5 percent sales tax would increase annual facilities construction and modernization costs for schools, depriving them of $216 million over ten years in needed upgrades absent additional funding. Similarly, over 10 years, a sales tax on services could potentially prevent nearly $1.9 billion of transportation-related projects from being completed. And a family-owned florist could expect to see its business and operating expenses increase by more than $26,000 a year.

INTRODUCTION

The State of California celebrated a record budget surplus in 2022; however in 2024 it finds itself in the midst of a severe fiscal situation. The Governor's Office announced in the May Revise that the State faces a $27.6 billion deficit in the 2024-25 fiscal year (excluding $17.3 billion of early budget actions) and a $28.4 billion deficit in 2025-26. [1] The California Legislative Analyst's Office (LAO) suggests that the budget shortfall could be even larger, given that they recently forecasted state revenues to come in $19 billion below the Governor's Budget across the 2022-23 to 2024-25 budget window.[2]

According to the California Department of Finance, the causes of the budgetary difficulties are straightforward: "The budget shortfall facing lawmakers in 2024… is rooted in two separate but related developments during the past two years—the substantial decline in the stock market that drove down revenues in 2022 and the unprecedented delay in critical income tax collections."[3] To elaborate, capital gains from high-income earners suffered when the stock market declined, and the State's reliance on personal income taxes and a highly progressive tax structure resulted in a drop in revenues. Additionally, a series of storm-related disasters affecting millions of taxpayers in early 2023 pushed the U.S. government to move income tax filing deadlines from April to November (and California conformed with this change), and the delay meant that the State could not see that revenues had fallen in time to make necessary adjustments to the previous budget.

Despite this confluence of factors, some have called for the State to solve its ongoing boom-and-bust budget cycles by enacting a sales and use tax on services.[4] The general argument here is that the role of sales and use taxes (hereafter "sales taxes" for simplicity) in funding the State's budget has diminished over time as the California economy evolved from being primarily goods-producing to being primarily services-oriented. A broader sales tax that includes services

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[1] Governor's Office, "Governor Newsom's Revised 2024-35 State Budget," Fact Sheet, May 10, 2024. Online at https://www.gov.ca.gov/wp-content/uploads/2024/05/FACT-SHEET_-May-Revise-2024_05.10.2024.pdf

[2] LAO, "Updated 'Big Three' Revenue Outlook," May 2, 2024. Online at https://www.lao.ca.gov/LAOEconTax/Article/Detail/777

[3] Department of Finance, *Governor's Budget Summary, 2024-25*, p. 1, January 10, 2024. Online at https://ebudget.ca.gov/2024-25/pdf/BudgetSummary/FullBudgetSummary.pdf

[4] As an example, see Skelton, George, "California's budget relies on the richest taxpayers, and we're paying the price," *Los Angeles Times*, April 22, 2024. Online at https://www.latimes.com/california/story/2024-04-22/column-californias-budget-relies-on-the-richest-taxpayers-and-were-paying-the-price

should then generate a large and stable source of revenue that would eliminate California's budget volatility.

In 2019 when Sen. Robert Hertzberg introduced Senate Bill (SB) 522, which would have imposed a sales tax on a range of "business services" in California, Encina Advisors analyzed the ramifications of such a services tax and issued a comprehensive report.[5] The report specifically addressed three claims being made at the time: that taxing business services would promote overall tax fairness, that a sales tax on business services would stabilize California's government revenue, and that taxing business services would not harm California's economic environment.

This whitepaper, the second in a series, revisits our 2019 report and updates the analysis on sales taxes on services and California's economic environment. It addresses the hidden costs that a sales tax on services would impose on businesses and consumers across California beyond the tax itself. It also demonstrates the financial impacts that such a tax would have in the aftermath of record-high inflation stemming from the Covid-19 pandemic—a sales tax on services would compound today's higher prices and interest rates, adversely affecting both consumers and businesses.

BACKGROUND ON SALES TAXES ON SERVICES

In the early 1930s, California established a sales and use tax on retailers conducting business in the state. Retailers have been required to remit *sales taxes* on all sales of physical goods and merchandise (tangible personal property) except for those sales specifically exempted by law (e.g., groceries and certain medical devices). Additionally, Californians who buy physical goods and merchandise from a business located outside of the state have been required to remit *use taxes* on these purchases if the out-of-state retailer did not collect California sales tax from the buyer. The current statewide sales and use tax rate is 7.25 percent, although most local jurisdictions in the state have added district taxes of up to 3 percent on top of this amount.

[5] Encina Advisors, LLC, *An Analysis of Sales Taxes on Business Services in California*, May 2019. Online at https://cfce.calchamber.com/wp-content/uploads/2019/05/Encina-Advisors-Business-Services-Tax-Report-CFCE-May-2019.pdf

California's sales and use tax does not apply to services except in certain circumstances. Services are defined as transactions where no transfer of physical goods or merchandise takes place—landscaping, accounting, legal advice, hairstyling, consulting, child care and contracting are just a few examples. The limited exceptions where the sales and use tax might apply include when a service is part of a bundled or mixed transaction. Exceptions might also occur when a service is inseparable from a physical good, such as the taxable sale of machinery that the seller must calibrate as a condition of the sale.

Policymakers and other stakeholders in California have explored at various times over the past twenty years expanding the sales and use tax to cover services. With respect to studies, the California Commission on Tax Policy in the New Economy in 2003 recommended that the state broaden the sales tax base to include selected services while lowering the tax rate to retain revenue neutrality, and that the state eliminate selected sales and use tax exemptions or exclusions.[6] In 2009, the Commission on the 21st Century Economy contemplated sales taxes on services as a potential option for overhauling California's tax system but ultimately decided against recommending a sales tax on services.[7] In 2011, the Think Long Committee recommended that a new sales tax on services be created and applied to all business and consumer services other than health care and educational services.[8] And in 2016, State Controller Betty Yee's Council of Economic Advisors on Tax Reform examined a sales tax on services among other ideas without making recommendations.[9]

With respect to legislative efforts to impose the sales and use tax on services, Assembly Member Joe Coto introduced Assembly Bill (AB) 9 in the 2005-06 session that would have extended the state sales tax to specified services such as accounting, legal and engineering

[6] California Commission on Tax Policy in the New Economy, *Final Report of the California Commission on Tax Policy in the New Economy*, December 2003. Online at http://www.californiacityfinance.com/CaComTaxPolicyNewEcon2003.pdf

[7] Commission on the 21st Century Economy (COTCE), *Report of the Commission on the 21st Century Economy*, September 2009. Online at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf

[8] Nicolas Berggruen Institute, *A Blueprint to Renew California: Report and Recommendations Presented by the Think Long Committee for California*, November 2011. Online at https://36z59wriv543qd814533ma8z-wpengine.netdna-ssl.com/wp-content/uploads/2018/10/Blueprint_to_Renew_ca.pdf

[9] California State Controller Betty T. Yee and the Controller's Council of Economic Advisors on Tax Reform, *Comprehensive Tax Reform in California: A Contextual Framework*, June 2016. Online at https://www.sco.ca.gov/Files-EO/Comprehensive_Tax_Reform_in_California_A_Contextual_Framework_06_16.pdf

services. Assembly Member Alyson Huber introduced AB 1963 in February 2012 which would have required the Legislative Analyst's Office to analyze how a sales tax on services would impact the state's revenue volatility. And Senator Hertzberg introduced SB 8 in December 2014, SB 1445 in February 2016, SB 993 in February 2018, and SB 522 in 2019 that would have imposed sales taxes on a broad range of services in the state. All of these efforts failed in their respective houses.

California is in fact like most other states when it comes to having no general tax on services. Only four states apply sales taxes to most services: Hawaii, South Dakota, New Mexico, and West Virginia. The vast majority of states apply sales taxes only selectively to services.[10]

INHERENT PROBLEMS WITH SALES TAXES ON SERVICES

While some see a sales tax on services as an innocuous way to raise revenue for state government, imposing such a tax actually generates a number of problems. These range from the practical considerations of administering the tax (e.g., how to determine where a purchaser of services received the benefit from those services to know if the tax applies?) to the economic distortions created if the tax is not imposed uniformly across all industries (i.e., exempting education, health care, and personal services) and across all jurisdictions (i.e., California vs. other states). These problems have been discussed in depth by other researchers and organizations, but we address a few of the more important issues below.

Compounds Cost Increases

Arguably, the most significant problem with a sales tax on services is the problem of pyramiding. The Council on State Taxation describes pyramiding as the situation where the same services are taxed multiple times as they move through production to final retail sale. This happens when a business purchases an input that is subject to the sales tax, and then the subsequent sales of the business include the same input costs in the sales price subject to the sales tax a second time.[11]

[10] It should also be noted that three states that enacted a broad sales tax on services in the past—Florida in 1986, Massachusetts in 1990 and Michigan in 2007—repealed them shortly after they went into effect because of widespread opposition from residents. In both Massachusetts and Michigan, the tax lasted less than two days.

[11] Cline, Robert, Andrew Phillips and Tom Neubig, *What's Wrong with Taxing Business Services: Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services*, Washington,

Consider the example of a California architect providing design services to a client. Architects regularly subcontract with engineering firms for specialized services, so the California architect would be required to pay sales taxes on the engineering services it utilized to meet the client's needs. The client would then pay sales taxes on the package of design services it received from the architect, which includes the engineering services as a component. Thus, the engineering services would be taxed at multiple points in the process and inflate the cost of services throughout. (The client effectively also would pay sales taxes on top of sales taxes.)

As a sales tax on services ripples through the production process, the effective tax rate faced by customers grows beyond what would have been intended by statute. We estimate that a 5.0 percent statutory sales tax on business services in California could result in an effective tax rate of between 6.1 percent and 8.1 percent, depending on the specific industry.

Creates an Uneven Playing Field for California Companies

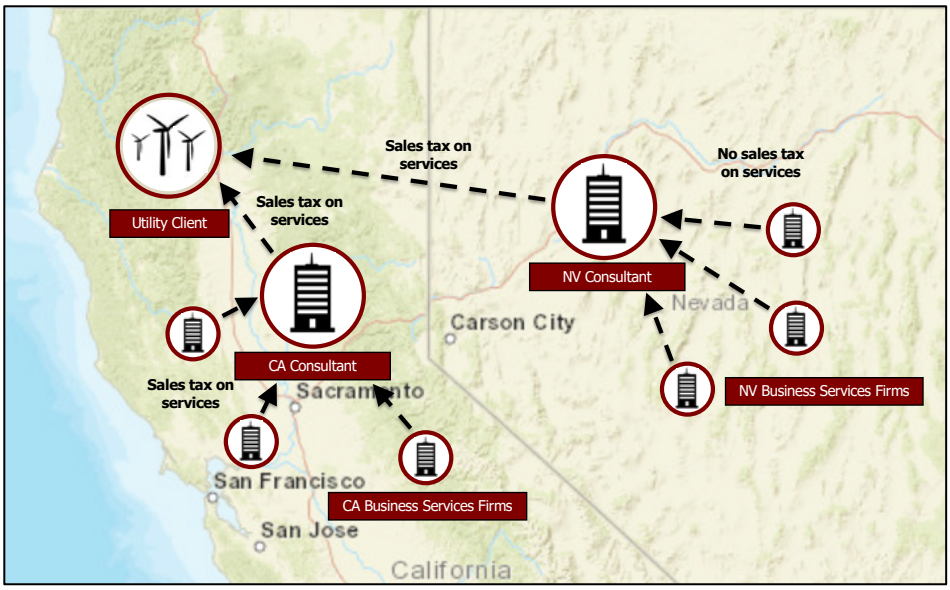
A sales tax on services can generate significant distortions in the economy, creating an uneven playing field that changes what people buy and from whom. One way that this occurs is through exemptions from the tax that are intended to shield certain consumers or industries. Prior California legislation such as SB 993 would have exempted numerous service industries, including health care services, education services, child care, rent, interest, and services provided by very small businesses. When a sales tax is applied to some industries and not others, it creates an artificial price differential between impacted industries and exempted industries. Economic theory suggests that when faced with such a situation, consumers will substitute lower-cost services for some of the higher-cost services (e.g., skip the tax preparer in favor of more child care). Thus, the tax creates winners and losers.[12]

Another way this occurs is by putting California companies at a disadvantage by artificially raising their cost structures relative to firms in other states. This is related to pyramiding, and happens because companies are likely to obtain many of their inputs locally. For example, think about a California consulting firm competing against a Nevada-based firm to perform work for a California utility. (See Figure 1 below for a notional example.) By necessity, each would rely on local janitorial and shredding companies as inputs for their services, however only the California janitorial and shredding companies would be subject to sales tax on services. Having to internalize these higher input costs would make the California consultant less competitive on price.

D.C.: Council on State Taxation, April 4, 2013. Online at https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/sales-taxation-of-services-and-business-inputs-study.pdf

[12] Economic theory also suggests there are wealth effects where the sales tax effectively reduces consumers' income and causes them to purchase less of everything.

Figure 1: Uneven Playing Field for California Companies



Sources: Encina Advisors, ESRI

Impacts Small Businesses Disproportionately

Small businesses are less able to adjust to a world with a sales tax on services than their large business counterparts. This is because large companies have the resources to house many business services internally, such as by establishing internal legal, accounting, and human resource departments, rather than by outsourcing them. In this way, large companies can effectively circumvent the sales tax for these services. Small businesses are resource constrained, however, meaning they do not have the funds or the workload to justify hiring additional administrative staff. In most cases they will continue to outsource many of these business services, putting them at a relative disadvantage.

Even if the sales tax were designed to exempt very small businesses from the tax (e.g., those making less than $100,000 annually, as was the case with one version of SB 993), hundreds of thousands of California small businesses would receive no relief. The added burden of the tax could result in some business closures as well as business flight. Reduced company workforces would also be likely, but for some very small firms, eliminating workers is not possible. This increases the likelihood that the underground economy could grow as some companies resort to paying for services under the table.

Increases Costs for Consumers

A sales tax on services, even one narrowly tailored to business services, unavoidably would increase costs for consumers. This is not just because individuals (as well as businesses) require the assistance of engineers, attorneys, and accountants, but it is also because consumers would

face higher prices for exempted, non-business services. The reason? Goods and services that people rely on daily also depend on business services in their production.

Take child care as a case in point. National statistics from the U.S. Bureau of Economic Analysis indicate that nearly 60 percent of the intermediate goods and services purchased by social assistance firms including child care involve business services.[13] The three largest expenditures by child care firms with respect to intermediate goods and services are other real estate (16.7 percent), miscellaneous professional, scientific, and technical services (8.3 percent), and insurance carriers and related activities (7.4 percent). Consequently, our calculations indicate that a 5 percent sales tax solely on business services would increase the cost of child care by 1.63 percent even if exempt from the tax.

Represents a Tax on Labor

Service industries tend to be labor-intensive, and as a consequence, a sales tax on services can be thought of as a tax on labor. Taxing labor would be expected to increase unemployment in the state.

Note that as of August 2024, California has an unemployment rate of 5.3 percent, which is already significantly higher than the state's unemployment rate from a year ago (4.8 percent) and the nation's current rate (4.2 percent). These numbers also mask the fact that not all demographics are experiencing the same rate of unemployment. For example, the August unemployment rate for blacks and Hispanics was much higher at 7.0 percent and 5.8 percent, respectively, compared to 5.2 percent for whites.[14]

Additionally, some important industries in California such as manufacturing and information (which includes the state's high-tech sector) are facing significant challenges. Manufacturing has lost 2.1 percent of nonfarm payroll employment over the past year while information has lost 3.9 percent. An environment of continued high interest rates and slowing economic growth promises to keep the pressure on these industries, and a sales tax on services would only exacerbate this pressure.

[13] U.S. Bureau of Economic Analysis, "The Use of Commodities by Industries – Summary," 2024.
[14] See https://labormarketinfo.edd.ca.gov/Publications/Labor-Market-Analysis/calmr.pdf

Requires Significant Implementation Costs

Applying a sales tax on services would impose significant costs on both private-sector businesses and state government. Businesses obviously would incur additional administrative costs to register with the California Department of Tax and Fee Administration (CDTFA) and report and regularly remit their sales tax payments. This burden would fall most heavily on small businesses, which have fewer administrative resources to handle tax collection and remittance. Small service providers could be impacted by carrying costs as well. Professional services firms such as engineering firms often wait 120 days or more to be paid by their clients. However, the CDTFA requires firms with an average monthly sales tax liability greater than $1,200 to file sales taxes quarterly but make monthly prepayments. The size of these prepayments could squeeze the cash flow of small companies.

Regarding costs to state government, the State Board of Equalization (BOE), now part of the CDTFA, noted that its operations would be significantly impacted if a tax on services were to be implemented. Based on analyses regarding two bills instituting sales taxes on services, AB 2540 in 2012 and SB 8 in 2015, the BOE suggested that extending a broad-based tax on service providers' sales could add a few hundred thousand additional taxpayers. This would require sufficient funding for the state to hire, house, and train staff; identify and register affected businesses; make programmatic changes; respond to taxpayer inquiries; provide outreach to taxpayers; perform audit and collection functions; establish effective refund and appeals programs; and perform other administrative duties to effectively administer a services tax. The BOE estimated that each additional 100,000 taxpayers registered would require an additional 250 staff positions and $32 million in ongoing funding.[15]

INFLATION AND SERVICES

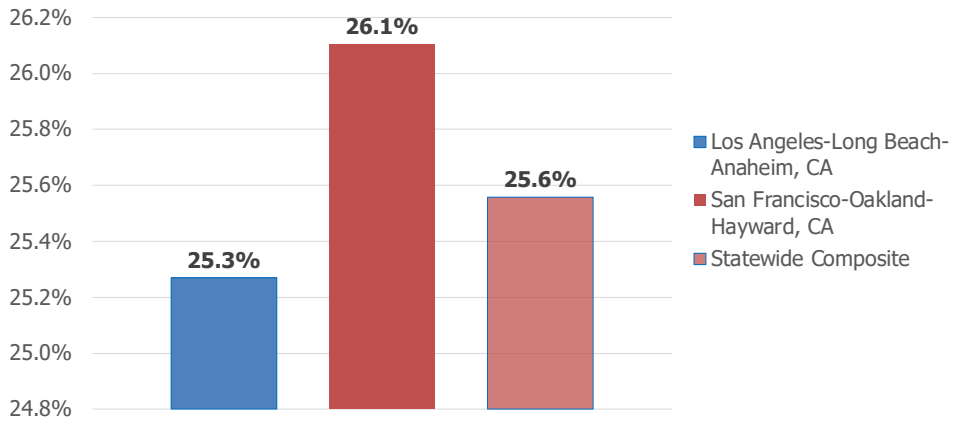
Milton Friedman referred to inflation as "taxation without legislation," and since the initial publication of our report in 2019, the United States suffered a bout of record-high inflation.[16] The dramatic growth in the cost of goods and services was caused by many factors, including supply chain disruptions resulting from the Covid-19 pandemic and the ongoing Russian invasion of Ukraine. The primary cause, however, was the federal government's fiscal stimulus enacted in response to the pandemic: Through assistance to families, businesses and states and through other programmatic spending, the federal government injected roughly *$5 trillion* into

[15] See https://labormarketinfo.edd.ca.gov/Publications/Labor-Market-Analysis/calmr.pdf
[16] Nationally, year-over-year inflation reached a high of 9.1 percent in June 2022, as measured by the Consumer Price Index.

the national economy.[17] Additionally, as the Federal Reserve raised interest rates to slow the economy and rein in inflation, the country also experienced higher costs to purchase houses and automobiles and to obtain business loans.

While inflation subsequently has moderated, the damage has already been done. Figure 2 shows the growth in the Consumer Price Index (CPI) for services (excluding rent of shelter) for the Los Angeles-Long Beach-Anaheim and San Francisco-Oakland-Hayward Metropolitan Statistical Areas from 2019 to 2024. Prices for services increased over this time by about 25.3 percent in the Los Angeles region and by approximately 26.1 percent in the San Francisco region. We estimate that statewide the average increase was 25.6 percent. This means that a potential sales tax on services would only compound the substantial price hikes that California consumers and businesses have been experiencing.

Figure 2: Percent Change in Consumer Price Index (CPI-U) for Services, Less Rent of Shelter 2019 (First Half) – 2024 (First Half)



Sources: Encina Advisors, ESRI

IMPACTS TO THE CALIFORNIA ECONOMY

We updated four brief case studies from our 2019 report to illustrate the implications that a sales tax on services would have on different California industries, adjusted for inflation. We found that instituting such a tax would create ripples of cost increases across the California economy, affecting business, consumers and government. The case studies comprise residential housing construction, K-12 school construction, SB 1 and transportation infrastructure, and small business.

[17] Parlaplano, Alicia, Deborah B. Solomon, Madeleine Ngo, and Stacy Cowley, "Where $5 trillion in pandemic stimulus money went," *New York Times*, March 11, 2022. Online at https://www.nytimes.com/interactive/2022/03/11/us/how-covid-stimulus-money-was-spent.html

Case Study 1: Residential Housing Construction

California is not building enough housing to meet demand. The California Department of Housing and Community Development (HCD) estimates that 2.5 million new homes will need to be built under the upcoming eight-year Regional Housing Needs Assessment (RHNA). At the same time, HCD acknowledges that the state is not expected to reach the target of 1.2 million units specified under the current RHNA.[18]

Could a sales tax on services exacerbate California's housing situation? SB 993, a previous sales tax on services bill, recognized the potential problem and specifically exempted the residential housing construction industry from the bill's proposed tax. However, the evidence suggests that a sales tax still would increase the cost of residential construction in California even with an exemption, and thus would increase the cost of housing in the state. This is because a variety of industries support residential housing construction, and many of these would be taxed.

According to the National Association of Home Builders, there are seven major components to the sale price of new residential housing:[19]

- *Finished Lot Cost:* Cost for land, including financing, all entitlements, permits, site investigations by technical consultants (e.g., geologists, civil engineers, biologists), and all improvements;
- *Total Construction Cost:* Housing construction costs covering site work (including architectural design and engineering), foundations, framing, exterior finishes, major systems, interior finishes and final steps;
- *Financing:* Cost of mortgage, including interest;
- *Overhead and General Expenses:* Salaries and benefits of administrative personnel of the homebuilder, office space, and outsourced services;
- *Marketing:* Advertising costs for the homebuilder;
- *Sales Commission:* Seller's fee; and
- *Profit.* Net profit for the homebuilder after operating expenses.

[18] California Department of Housing and Community Development, *A Home for Every Californian: 2022 Statewide Housing Plan*, March 2022. Online at https://statewide-housing-plan-cahcd.hub.arcgis.com/
[19] Ford, Carmel, *Cost of Constructing a Home: Special Study by National Association of Home Builders Economics and Housing Policy Group*, Washington, D.C.: HousingEconomics.com, December 2017.

Figure 3: Increase in Housing Costs for New Single-Family Housing in California from a Sales Tax on Services

Housing Cost Component	2024 Cost Estimate	Cost with 5% Sales Tax on Services
Finished Lot Cost	$147,466	$157,337
Total Construction Cost	$381,121	$385,096
Financing Cost	$12,240	$13,235
Overhead and General Expenses	$35,001	$37,398
Marketing Cost	$8,518	$9,102
Sales Commission	$27,969	$28,978
Profit	$73,579	$75,624
Total Sales Price	$685,894	$706,770
Difference	-	$20,876
Percent Increase	-	3.0%

Source: Ford, Carmel (December, 2017); Encina Advisors

Figure 3 shows these estimated costs for new single-family housing construction in California. The table takes national estimates for 2017 from the National Association of Homebuilders and adjusts them for California using data from the U.S. Census Bureau on the average sales price of houses sold by region and for inflation using CPI. We modeled a 5 percent sales tax on business services as follows: We associated each of the first five cost categories (i.e., finished lot cost, total construction cost, financing cost, overhead and general expenses, and marketing cost) with a 2-digit NAICS sector. To account for pyramiding in these five cost categories, we applied the 5 percent sales tax rate on the purchases of intermediate goods and services for these sectors as appropriate, and recalculated the category costs. To account for the sales tax on final services provided through these five cost categories, we then applied the 5 percent tax to the recalculated costs for each category except total construction cost. We did not apply pyramiding or final sales tax factors to the sales commission and profit categories, but instead kept these as percentages of the final sales price (4.1 percent and 10.7 percent, respectively).

Figure 3 shows that even if residential housing construction (i.e., total construction costs) were exempted from the tax, the sales price of new housing would increase markedly because of all of the supporting services. A 5 percent sales tax on services would add nearly $21,000 to the price of a new home, a 3 percent increase.

Case Study 2: School Construction and Rehabilitation

Californians have paid increasing attention of late to the poor conditions of their K-12 school facilities. These facilities, encompassing nearly 10,000 public schools including more than 1,200 charter schools, provided instruction and educational services to about 5.8 million students in 2023-24.[20] Yet school districts argue that they do not currently have sufficient resources to maintain their facilities, modernize their buildings, and develop new facilities to accommodate enrollment growth. As researchers at the University of California Berkeley have noted, the state's public-school districts – particularly those in low-wealth areas – experience significant funding shortfalls for their facilities leaving them unable to spend the nearly $18 billion a year in needed investments.[21] This lack of resources is one reason why California voters in 2016 passed Proposition 51, which authorized $7 billion in state general obligation bonds for the construction and modernization of K-12 schools, and why Proposition 2, the $10 billion Public Education Facilities Bond Measure, is on the ballot this November.

Consequently, given the state's sizeable need to invest in its school facilities, it is imperative that its limited dollars are spent effectively. Could a sales tax on services degrade the effectiveness of California's school construction and rehabilitation efforts? California Department of Education (CDE) statistics show that in 2017-18, the state spent $709 million on capital outlay for facilities acquisition and construction as well as for plant maintenance and operations (including state General Fund expenditures and County School Service Fund expenditures).[22] The CDE breaks down capital outlay into six categories, and the statistics provide allocation percentages of these expenditures: Land (3.8 percent); land improvements (5.4 percent); buildings and improvements of buildings (49.2 percent); books and media for new school libraries or major expansion of school libraries (0.03 percent); equipment (35.6 percent); and equipment replacement (6.1 percent).

We modeled a 5 percent sales tax on services as follows: We adjusted 2017-18 spending for inflation using the CPI. We then associated each of the cost categories with a 2-digit NAICS sector, accounted for pyramiding in these cost categories by applying the 5 percent sales tax rate on the purchases of intermediate goods and services for these sectors as appropriate, and

[20] See https://www.cde.ca.gov/ds/sd/cb/ceffingertipfacts.asp

[21] See Jain, Liz S. and Jeffrey M. Vincent, *Building Pressure: Modeling the Fiscal Future of California K-12 School Facilities*, Berkeley: Center for Cities and Schools, University of California Berkeley, September 2016 at http://citiesandschools.berkeley.edu/uploads/Jain__Vincent_2016_Building_Pressure_final.pdf

[22] See http://www.ed-data.org/state/CA

recalculated the category costs. We then applied the 5 percent tax rate to the final purchases of land improvements, buildings and improvements of buildings, and books and media for new school libraries.

Figure 4: Increase in School Construction Costs in California from a Sales Tax on Services

Facility Component	2024-25 Cost Estimate	Cost with Pyramiding	Cost with 5% Sales Tax on Services
Land	$35,942,408	$36,522,190	$36,522,190
Land Improvements	$51,879,380	$52,793,356	$55,433,024
Buildings and Improvements	$470,310,778	$475,216,061	$479,968,222
Books and Media	$244,117	$249,013	$261,464
Equipment	$339,624,817	$346,259,405	$346,259,405
Equipment Replacement	$58,430,331	$59,571,770	$59,571,770
Total Expenditure	$956,431,831	$970,611,796	$978,016,075
Difference	-	$14,179,965	$21,584,244
Percent Increase	-	1.5%	2.3%

Source: CDE; Encina Advisors

Figure 4 above shows that a 5 percent sales tax on services would increase annual facilities construction and modernization costs by $22 million in 2024-25 for state and local governments. That represents a cost increase of 2.3 percent from a tax not intending to target schools. More importantly, it means that over 10 years, potentially $216 million of needed school upgrades would not get completed absent additional funding.

Case Study 3: SB 1 and Transportation Infrastructure

The Legislature passed SB 1, the Road Repair and Accountability Act of 2017, to provide a significant infusion of new state funding to California's transportation system. This legislation was primarily a response to the deteriorating condition of California's infrastructure and the allegedly inadequate resources the state had at the time to address it. As SB 1 notes, over the next 10 years the state faces a $59 billion shortfall to adequately maintain the existing state highway system, while cities and counties face a $78 billion shortfall to adequately maintain the existing network of local streets and roads. These poorly maintained roads mean that California motorists are spending $17 billion annually in extra maintenance and car repair bills, which is more than $700 per driver.[23]

[23] See the text of SB 1 here https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180SB1

Over 10 years, SB 1 will provide $53 billion for transportation, including $15 billion for state highway repairs and maintenance, $4 billion in state bridge repairs, $3 billion for state trade corridors, and $2.5 billion for the state's most congested commute corridors. SB 1 also will provide $15 billion for the maintenance and repairs of local roads, $2 billion in matching funds for local partnership projects, $7.6 billion for transit and intercity rail, and $1 billion for active transportation projects including bicycle lanes and pedestrian crosswalks. It is estimated that within 10 years, SB 1 will add $6.8 billion annually to California's transportation system, compared to about $7.2 billion in state funding for transportation programs in 2016-17.[24]

Could a sales tax on services reduce the impact of SB 1 funding? We modeled a 5 percent sales tax on services using the following information: For 2019-20, the Newsom administration proposed to spend a total of $4.8 billion in SB 1 funding, including $4.5 billion in the following identified priorities:[25]

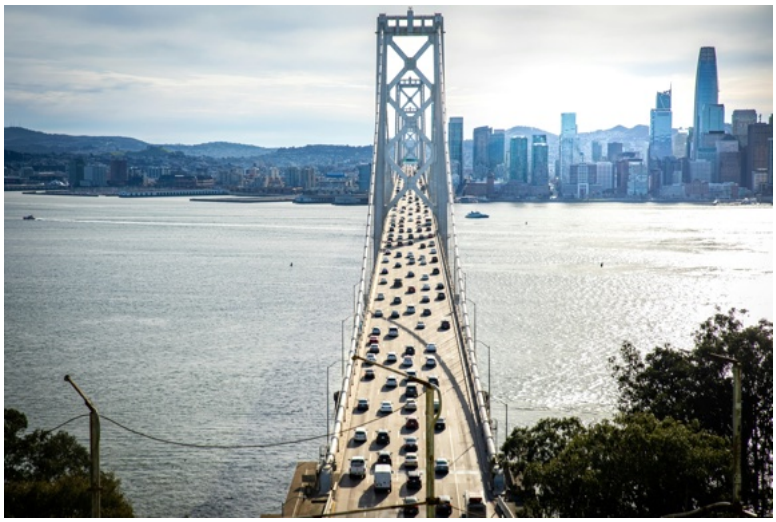
- *Maintenance and Rehabilitation of the State Highway System:* $1.2 billion;
- *Repairs to Local Streets and Roads:* $1.2 billion;
- *Maintaining and Repairing the State's Bridges and Culverts:* $400 million;
- *Trade Corridor Enhancement Program*: $307 million;
- *Solutions for Congested Corridors Program:* $250 million;
- *Local Transit Operations:* $458 million;
- *Capital Improvements for Transit, Commuter and Intercity Rail:* $386 million;
- *Local Partnership Projects:* $200 million;
- *Active Transportation Program Projects:* $100 million;
- *Expansion of Freeway Service Patrols:* $25 million; and
- *Local Planning Grants:* $25 million.

[24] See a report on 2018-19 transportation issues by the LAO at https://lao.ca.gov/Publications/Report/3745

[25] California Governor's Office, Governor's Budget Summary, 2019-20, Sacramento: California Governor's Office, January 9, 2019. Online at http://www.ebudget.ca.gov/2019-20/pdf/BudgetSummary/FullBudgetSummary.pdf

With the exception of local transit operations, the expansion of freeway service patrols and local planning grants, these priorities represented $4.043 billion in capital investments.

Transportation construction projects generally all have three cost components: preliminary engineering, right of way, and construction. Here, preliminary engineering represents the design phase of a project and its associated expenses, right of way refers to the purchase of the land required for construction of the project, and construction costs are the expenses incurred during the build phase including labor and materials. Preliminary engineering, right of way, and construction costs can differ across projects due to multiple factors such as project type (e.g., roadway, bridge, railway), construction type (e.g., new construction, rehabilitation), number of lanes, location (e.g., urban, rural) and terrain. That said, the Midwest Economic Policy Institute examined each state's highway preliminary engineering, right of way and construction costs from 1993 to 2015 and normalized these costs using each state's total lane miles. For California in particular, the Midwest Economic Policy Institute estimated that per lane mile, preliminary engineering, right of way and construction averaged 20 percent, 8 percent and 72 percent of project costs, respectively.[26]



For the construction-related categories of SB 1, we applied these preliminary engineering, right of way and construction percentages to the expenditures and associated each percentage with a 2-digit NAICS sector. We associated the operations-related expenditures and the local planning grants with separate 2-digit NAICS sectors. To account for pyramiding, we applied the 5 percent sales tax rate on the purchases of intermediate goods and services for these sectors as appropriate, and recalculated the category costs. We then applied the 5 percent tax rate to the final purchases of the estimated non-materials portion of the construction-related categories and to the expansion of freeway service patrols that are privately run. Finally, we used CPI to adjust all costs to today's dollars.

The results are presented in Table 5. Table 5 shows that a 5 percent sales tax on services would increase annual costs for SB 1 funded activities by $187 million for state and local governments. That means a cost increase of 3.2 percent. Consequently, over 10 years, a sales tax on services could potentially prevent nearly $1.9 billion of transportation-related projects from being completed.

[26] Craighead, Mary, A Comparison of Highway Construction Costs in the Midwest and Nationally, St. Paul: Midwest Economic Policy Institute, March 20, 2018. Online at https://midwestepi.files.wordpress.com/2017/05/cost-per-lane-mile-nationally-and-in-the-midwest-updated-final.pdf

Figure 5: Increase in SB 1 Construction Costs in California from a Sales Tax on Services (in Millions)

Category	2024-25 Cost Estimate	Cost with Pyramiding	Cost with 5% Sales Tax on Services
Maintenance & Rehab. of State Highway System	$1,558	$1,578	$1,611
Repairs to Local Streets and Roads	$1,558	$1,578	$1,611
Maintaining and Repairing the State's Bridges	$519	$526	$537
Trade Corridor Enhancement Program	$399	$404	$412
Solutions for Congested Corridors Program	$325	$329	$336
Local Transit Operations	$595	$601	$601
Capital Improvements for Transit	$501	$507	$518
Local Partnership Projects	$260	$263	$268
Active Transportation Program Projects	$130	$131	$134
Expansion of Freeway Service Patrols	$32	$33	$35
Local Planning Grants	$32	$33	$33
Total	$5,910	$5,982	$6,097
Difference	-	$72	$187
Percent Increase	-	1.2%	3.2%

Source: Governor's Office, January 9, 2019; Encina Advisors

Case Study 4: Small Business – Relles Florist

Relles Florist is a Sacramento institution located in the heart of Midtown. Opened in October 1946 by Ross Relles Sr., the small business provides arrangements of fresh-cut flowers to its customers, primarily in the greater Sacramento metropolitan region. The company emphasizes obtaining locally grown flowers to the extent possible, but will source from all over the world. Relles Florist is now managed by Jim Relles, Ross's son, and employs multiple other family members as well.[27]

Over the past few years, Relles Florist has been squeezed by financial pressures driven by both the marketplace and by government. The explosion of web retailers has created additional competition for the company. This has forced the company to look for ways to cut costs to keep prices down and maintain sales. At the same time the company has seen an increase in its overhead costs. For example state and local minimum wage laws – which so far have increased Sacramento's minimum wage from $10.00 an hour in 2016 to $16.00 an hour currently – have increased the company's costs. Despite the fact that most of the shop's 22 full-time employees already are paid more than minimum wage, any increase in the minimum has a cascading effect across all other salary levels.

[27] Information for this case study was gathered through an in-person interview with Jim Relles on April 26, 2019 and through Arrington, Debbie, "Sacramento's landmark Relles Florist celebrates 70 years of sweet success," *The Sacramento Bee*, October 17, 2016.

Theoretically, Relles Florist should not be substantially impacted by a sales tax on services; as a company in the retail trade industry, the shop is not primarily a services provider and already collects and remits sales tax on its sales and delivery of fresh-cut flowers and arrangements. But could a sales tax on services affect the financial health of Relles Florist? We reviewed the company's profit and loss statement for its 2017 fiscal year, and found that 25 percent of its nearly $1.5 million in business and operating expenses would be impacted by a sales tax on services (based on the taxed services identified in SB 993). This includes services that would directly be taxed, including delivery services, legal, accounting, advertising, website hosting, and payroll service fees. It also includes services that would become indirectly more expensive due to pyramiding, including auto repair and maintenance, laundry services, and parking.

For a sales tax on services going into effect today, we estimate that such a tax would increase Relles Florist's business and operating expenses by more than $26,000 a year. This represents a 1.3 percent increase to the company's total expenses, but one that cannot necessarily be passed on to consumers given the competition in the industry. Jim Relles noted that he does not want to reduce staffing levels, but the tight margins mean the company does not have a lot of flexibility, so there might be nowhere else to cut costs.

CONCLUSION

Our whitepaper demonstrated that imposing a sales tax on services would generate a number of problems for California businesses and consumers. These are hidden costs that go beyond the statutory amount of the tax itself.

Notably, through pyramiding, a sales tax on services would compound the statutory tax resulting in a much higher effective tax. It would create an uneven playing field for California companies, disproportionately affect small businesses, increase costs for consumers even if personal services are exempted, and hurt labor-intensive industries. Moreover, it would increase administrative costs for California state government significantly.

In the aftermath of record-high inflation stemming from the Covid-19 pandemic, a sales tax on services would only exacerbate today's higher prices and interest rates. And the financial impacts would be severe and wide ranging across California—from residential housing construction, to school construction and rehabilitation, to transportation infrastructure, to family-owned florists.