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MEMORANDUM

April 23, 2010

TO: Interested Persons

FROM: Fiona Sigalla, Economist, (303) 866-3556

SUBJECT: Broadening the Sales Tax to Services

This memorandum estimates how much the state sales tax rate could be lowered if the tax base were broadened to include additional services that are not currently taxed. If services were applied to the tax base, a rough estimate suggests that the same amount of revenue could be generated with a tax rate to 2.4 percent. This estimate includes consumer purchases of services and excludes business purchases from the tax base. At the current tax rate, about $550 million would be collected from extending the tax base to consumer services.

Table 1 details the services that are included in this estimate.

How the Estimate was Generated

This estimate was generated using data from a 2006-2008 average of personal consumption expenditures by product from the Bureau of Economic Analysis. National data was apportioned to Colorado using the state's share of personal income for 2008. Data from the 2008 Consumer Expenditure Survey produced by the Bureau of Labor Statistics (BLS) was also used to judge the reasonableness of this estimate.

This methodology includes revenues collected by other states on purchases made by Colorado residents on out-of-state consumption. However, it excludes revenues collected from sales tax on purchases made by non-Colorado residents visiting the state. It can be assumed that these biases offset to some degree.

Taxation of Business Services

Business purchases of services have not been included in this analysis. Staff has been unable to find adequate data for estimating the tax revenue from extending the base to business purchases of services. If business purchases were included in the tax base, the revenue neutral sales tax rate would be lower than the aforementioned 2.4 percent.

Most researchers do not recommend taxing business purchases because it is not a final purchase and can cause distortions in the economy.

Pyramiding. The sales tax is generally a low tax rate applied to purchases. The sales tax does not change the relative prices between products when the same tax rate is applied to a broad base of items. However, when taxing business purchases, the tax rate increases as the same product is taxed numerous times during the production process. This results in a higher tax rate for items with many steps in the production process and distorts the relative prices of products.

Vertical integration. A sales tax on business transactions only applies when a purchase is made. Large firms tend to require fewer purchases than small businesses to produce their products. For example, a large firm is more likely to have a legal department to provide legal services, while a small firm would purchase legal services from another firm. Thus, items produced by large firms would have a lower tax rate than the identical item produced by a small firm. This encourages small firms to consolidate into larger firms to reduce their tax burden. This process is referred to as vertical integration.

Table 1. Broadening the State Sales Tax Base		
Services Already Subject to the State Sales Tax	Untaxed Services Excluded from State Tax Base and this Analysis	Untaxed Services Added to the State Sales Tax Base for this Analysis
• Food and drinking services • Lodging • Leasing and rental of goods • Telephone services, including cell phone service for local (intrastate) service only	• Housing and utilities • Health care, including health insurance • Education • Public transportation • Social services and religious activities, including child care and social assistance	• Recreation services, including memberships, admissions, gambling, veterinary services, and audio, video, and photo processing • Motor vehicle maintenance and repair • Parking • Land line telephone long distance • Insurance, including life, homeowners, and motor vehicle • Mail and package delivery, excluding U.S. postal service • Financial services, fees, and commissions • Legal, accounting, and other business services • Personal care services, including hairdressing, personal grooming, dry cleaning, and clothing repair • Household maintenance, including domestic services, moving, storage and freight services, and repair of household items • Expenditures of nonprofit institutions serving households (does not include purchases)