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January 29, 2004

WILL TAXING ADDITIONAL SERVICES HURT IOWA'S ECONOMY?

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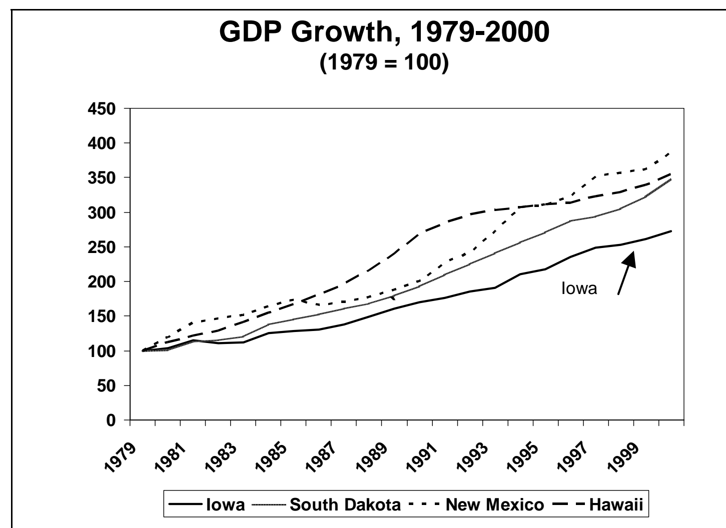
Summary

The Governor's proposal to expand the base of Iowa's sales tax to include more business and professional services has drawn fire from some who claim that the expansion would harm businesses and economic growth in the state. Three states, however, have for many years fully taxed services, and evidence from those three states — South Dakota, New Mexico, and Hawaii — call into question the validity of claims of economic harm.

- Each of the three states that fully tax services had stronger economic growth than Iowa over the past two business cycles.
- Employment growth in small businesses over the decade of the 1990s was stronger in two of the three states than it was in Iowa.
- In each of the three states that fully tax services, the rate of new business formation was higher than it was in Iowa.

Taxing services used by businesses may have an uneven effect on different types of businesses, depending on whether they purchase certain types of services or provide them with company employees. That does not mean, however, that taxing services is on balance a negative policy with respect to businesses or the economy. There are several positive benefits from taxing services more broadly.

- The consumption of services is growing while the consumption of goods is declining. Thus revenues from a sales tax without a broad base that includes services decline relative to the economy over time. Taxing services allows more adequate revenue growth to support public services.



- An adequate level of public services is, in turn, an important component of a positive business climate. Studies have shown that good schools, highways, and

amenities help to attract and retain businesses, and are often rated by businesses as more important factors in location decisions than tax levels.

- A broad sales tax base improves revenue stability. Research suggests that revenues from a broad-base sales tax fall less in economic downturns. This lower volatility lessens the chance that other types of taxes, including corporate income taxes or property taxes that businesses pay, will have to be raised during fiscal crises to make up for flagging revenues.

Indeed, one would not expect a policy such as broadening the sales tax base to have much direct effect at all on economic growth. Taxes represent a very small share of the cost of doing business, which is why studies of the impact of taxes on various measures of economic growth show at most a very modest effect. Since the states that have long taxed an extremely broad array of services (well beyond what currently is proposed for Iowa) do not seem to have suffered economic harm, it may be that the positive advantages of a broader sales tax — revenue growth that tracks economic growth, the ability to provide better public services, and lower revenue volatility — outweigh any negative effects such a tax might (or might not) have.

Broad-Base Sales Taxes

On January 16, Governor Vilsack proposed an expansion of the base of Iowa's sales tax to include more business and professional services. The governor's proposal addresses a well-know problem in public finance. The part of the U.S. economy that is growing the fastest is the services sector, and the consumption of services is growing faster than the consumption of goods.[1] As a result, the revenue from a state sales tax that fails to include a broad array of services in its definition of taxable sales does not keep up with economic growth and thus does not keep up with the normal rise in the cost of state and local government over time.

Many states have addressed this problem by periodically raising sales tax rates. During the 1990s, there were 28 state sales tax rate increases.[2] A rate hike does increase sales tax revenue immediately, but it fails to solve the longer-term problem of revenue growth. The revenue growth problem can only be solved by amending the definition of taxable sales to better match changing consumption trends.

An adequate level of yearly revenue growth is important for maintaining an adequate level of public services. An adequate level of public services is, in turn, an important component of a positive business climate. Studies have shown that good schools, highways, and amenities help to attract and retain businesses, and are often rated by businesses as more important factors in location decisions than tax levels.[3]

The stability of a tax system is also important to businesses, because it facilitates long-range planning. Broadening the base of the sales tax to include most services can improve revenue stability in two ways. First, it lessens the chance that sales tax rates or the rates on other taxes will have to be raised frequently to compensate for the eroding base of the sales tax. Second, there is evidence that a broad sales tax is more stable than a sales tax with a narrower

base over the course of business cycles; revenues from a broad-base sales tax fall less in economic downturns.[4] This lower volatility lessens the chance that other types of taxes, including corporate income taxes or property taxes that businesses pay, will have to be raised during fiscal crises to make up for flagging revenues.

Despite these advantages, some have objected to the extension of the sales tax to business and professional services because they are concerned about a potential adverse effect on economic development and growth. They often base that concern on the fact that a sales tax on business and professional services can have a differential impact on different types of businesses. For example, a business that maintains its own accounting department would not pay sales tax on its accounting services, while businesses that contract with an outside firm for those services would be subject to sales tax on the services it buys.[5] While this differential undeniably exists when services are included in the sales tax base, there is no evidence that the differential — which would vary greatly from business to business and service to service — has any negative impact on economic growth. Indeed, a look at the performance of the states that do broadly tax services suggests that the economic growth of these states has been better than Iowa's economic growth.

Economic Growth in Iowa and in States Broadly Taxing Services

There are three states that for many years have broadly taxed all types of services under their sales tax. They are South Dakota, New Mexico, and Hawaii. Each of these states taxes all services unless they are explicitly exempted — which few are. This is a much broader taxation of services than Iowa's current or proposed sales tax, which includes only those services specifically enumerated as taxable.

If a broad sales tax that includes business and professional services impeded economic growth, one would expect to see some evidence of economic growth problems in South Dakota, New Mexico, and Hawaii. In fact, however, all three states have experienced economic growth that has been stronger than Iowa's over the past two decades.

Table 1 shows economic growth as measured by Gross State Product over the past two business cycles. The data show that economic growth has been much stronger in Hawaii, New Mexico, and South Dakota than in Iowa during this period. Iowa's economy grew at an average rate of 4.9 percent a year from 1979 to 2000, while economic growth in each of the three states that tax business and professional services exceeded six percent a year.

Specific sectors of the economies of the four states showed similar patterns. Two of the three states had much stronger growth than Iowa in manufacturing. All three states had much stronger growth than Iowa in the finance, insurance, and real estate sectors, and the services sector as a whole. These are the sectors that could be expected to be affected by a broad sales tax on services. While the picture is more mixed for the subcategory of business services, South Dakota had much stronger growth than Iowa and Hawaii's growth was not much less than Iowa's

Table 1
Average Annual Change in Nominal Gross State Product, 1979 - 2000

	Iowa	South Dakota	New Mexico	Hawaii
Total GSP	4.90%	6.12%	6.65%	6.22%
Manufacturing	4.17%	7.94%	11.12%	2.84%
Finance, Insurance, and Real Estate	6.13%	8.81%	6.78%	7.12%
Services	7.47%	8.54%	8.73%	7.85%
Business Services	8.42%	11.58%	5.96%	8.07%

Potential Impact on Small Businesses

Even if broadly taxing services does not impede economic growth as a whole, it is possible that it could have a negative impact on small businesses. This is because it is the smaller businesses that generally must buy their services from outside vendors, while larger businesses can afford in-house staff to provide many services. Again looking at the three states that tax most services in comparison to Iowa, however, one does not find evidence of a negative effect on small businesses.

Data from the U.S. Small Business Administration shows that employment growth in businesses that have fewer than 100 employees was somewhat stronger in two of the three states that broadly tax services than it has been in Iowa. Between 1990 and 2000, employment in Iowa small businesses grew by just under one percent per year, while employment growth was 1.8 percent per year for South Dakota small businesses and 1.6 percent per year in New Mexico small businesses. Employment growth in Hawaii small businesses declined slightly, perhaps due to the turmoil in the Asian economies in the late 1990s.[6]

Table 2
Average Annual Change in Employment,
Firms with Less than 100 Employees, 1990 - 2000

Iowa	0.97%
South Dakota	1.76%
New Mexico	1.61%
Hawaii	-0.22%

Source: U.S. Small Business Administration

Still another measure suggests that broadly taxing services does not impede the development of new small businesses. In 2000, the last year in which the economy was fully healthy, the three states that broadly tax services each had a higher rate than Iowa of new business formations — the number of new businesses established relative to the total number of firms in the state. Each of the three states also had a better record than Iowa with respect to net business formations, that is, business formations less terminations.[7] (See Table 3.)

Table 3
Rate of New Firm Formations, 2000

	Rate of Firm Formations*	Net Rate of Firm Formations* (Formations less Terminations)
Iowa	8.2%	-2.7%
South Dakota	9.7%	1.5%
New Mexico	14.0%	-1.5%
Hawaii	13.6%	0.8%

*New firm formations and firm terminations as a percent of the total number of firms in the state as of the beginning of 2000.
Source: U.S. Small Business Administration, Small Business Economic Indicators 2000.

Implications

Comparisons such as these do not prove the lack of a negative impact from broadly taxing services, nor do they prove that taxing services yields positive gains. Each of the four states has many unique features, strengths, and weaknesses that contribute to the economic growth and job creation results. For example, New Mexico's natural resource base and location in the fast-growing Southwest gives it some advantage. Hawaii is a major tourist destination, but it also was adversely affected by the weakness in Asian markets in the late 1990s. South Dakota uses the sales tax as its major state revenue source, and does not have income taxes.

Despite all of these differences, the data strongly suggest that a negative impact from taxing services is unlikely. Most of the measures show stronger growth in the states taxing business and professional services than in Iowa. While it is easy to show that some specific businesses will have to pay more taxes than others when the sales tax is extended in this manner, the assertion that such a differential will lead to lower economic growth has not been proven.

One would not expect a policy such as broadening the sales tax base to have much effect at all on economic growth. Taxes represent a very small share of the cost of doing business, which is why studies of the effect of taxes on various measures of economic growth show at most a very modest impact. Moreover, the positive advantages of a broader sales tax — revenue growth that tracks economic growth, the ability to provide better public services, and lower revenue volatility — may very well outweigh any negative effects such a tax might (or might not) have.

Endnotes

[1] Consumption of services has risen from 44 percent of total consumption in 1969 to 59 percent of total consumption in 2002. Over the same period, consumption of nondurable goods has declined from 42 percent to 28 percent of consumption, and the consumption of durable goods has declined slightly. U.S. Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/bea/dn/nipaweb/TableView.asp#Mid

[2] There were eight rate decreases, but some of them were temporary. William F. Fox, "Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crisis," Tax *Notes*, August 4, 2003.

[3] See for example, Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March-April 1997, reprinted in *State Tax Notes*, June 23, 1997, pp. 1883-95; Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, D.C., 1996; Timothy Bartik, *Who Benefits From State and Local Economic Development Policies?*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan, 1991.

[4] Empirical research into this question has produced mixed results, but on balance suggests that expanding the sales tax base to encompass more services does reduce sales tax volatility at least moderately. A 1992 study by economists Richard F. Dye and Therese J. McGuire, for example, simulated growth in a hypothetical state sales tax base that incorporated personal services (like haircuts), personal business services (like investment counseling), recreation services, utilities, and telephone service. The study found such a broad sales tax base to be less volatile than the goods dominated base characteristic of most states. "Expanding the Sales Tax Base: Implications for Growth and Stability," in William F. Fox, *Sales Taxation: Critical Issues in Policy and Administration*, Praeger Publishers, 1992, Table 12.2, p. 173.

[5] This phenomenon is technically called pyramiding, because the business pays sales tax on a service that is used in the process of producing the final good or service. Depending on market conditions, the sales tax paid may be included in the final price of the good, which then may itself be subject to sales tax. Ideally, a sales tax would tax only final goods, so each transaction would be taxed only once. In practice, however, virtually all states have some degree of pyramiding in their sales taxes, and sales taxes on both goods and services fall on a wide variety of intermediate goods.

[6] Data is from March of each year. Earlier years were not available. Since Hawaii experienced strong growth in the 1980s, it is likely that a longer period of analysis would show that small businesses grew more rapidly in Hawaii than in Iowa. United States Small Business Administration, www.sba.gov

[7] Source: U.S. Small Business Administration, Small Business Economic Indicators 2000. www.sba.gov/advo/stats/#state